

Is the validity of a drag-along clause subject to specific requirements?

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Background

Drag-along clauses are often found in shareholders' agreements of joint stock companies. They provide an equity capital sale mechanism which ensures that if a third party offers to acquire the entire equity capital of the company, the majority shareholder has the option of benefiting from such offer and may use it to compel the minority shareholder to sell its entire participation to the would-be acquirer.

Majority shareholders usually request such clauses to protect their interests; they allow them to divest themselves of their participation without opposition from minority shareholders and thereby reap the benefits that accrue from the sale of the entire corporate stock. The use of drag-along clauses is intended to prevent situations in which a potential purchaser wants to acquire 100% of a target's shares at an advantageous price, but the minority shareholder does not intend to sell its shares. In this situation the clause will require the minority shareholder to sell its participation on the same terms and conditions as those negotiated by the majority shareholder and the acquirer. Drag-along clauses are often inserted into the bylaws of target companies.

Facts

Tecno was owned by two shareholders, one of which represented 60% of the entire corporate capital. Tecno's bylaws contained a drag-along clause whereby a majority shareholder that intended to sell its entire equity participation was entitled to offer a third-party acquirer the minority shareholder's participation at the same price and on the same terms. If a third-party acquirer made an irrevocable offer to the majority shareholder to purchase all of Tecno's corporate capital, the majority shareholder was required to inform the minority shareholder, which would be obliged to sell its shares unless it decided to exercise its pre-emption right by purchasing the majority shareholder's shares.

The majority shareholder, having negotiated and accepted a third party's binding offer to acquire Tecno's entire corporate capital, informed the minority shareholder of the proposal and invited it to state whether it intended to exercise its pre-emption right.

The minority shareholder believed the drag-along clause to be invalid. It brought an action before the Court of Milan and obtained interim measures to prevent the sale of its shares and the registration of the related transfer deed.

The majority shareholder and the acquirer initiated arbitration. Among other things, they sought to complete the transfer of Tecno's entire share capital to the acquirer. While the arbitration was pending, the acquirer submitted a petition to the court for the seizure of the minority shareholder's shares. The minority shareholder joined the proceedings, claiming that the contract for the transfer of shares had never been completed and that it was ineffective, as the drag-along clause was invalid.

The court rejected the acquirer's petition and on March 31 2008 it declared the clause invalid.

Decision

The court held that the drag-along clause limited the power of the minority shareholder to negotiate the sale of its equity participation. Such a limitation is valid only if it complies with general legal principles on limitations on share transfer and with the principle that, in the event of a compulsory sale, the loss of the shareholder's capacity as such is balanced by a fair price for the participation being sold.

Therefore, the court considered that the drag-along clause can be deemed valid if "the obligation on a minority shareholder to sell its participation is counterbalanced by an adequate sale price".

The court held that the fact that the minority shareholder had a pre-emption right was insufficient to satisfy the condition requiring fair value for its participation because the determination of the sale price would depend on an arbitrary assessment by the majority shareholder, which would negotiate the price with the acquirer. Objective criteria must be identified in order to guarantee an adequate assessment of the value of a participation that is subject to compulsory sale.

The court indicated that the proper criteria are provided by Articles 2437ter(2) and (4) of the Civil Code concerning the liquidation of a shareholder's participation in the event of withdrawal. By this reasoning, the drag-along clause is valid if the sale price of the minority shareholder's participation is at least equal to the price that would be due to the minority shareholder on its withdrawal from the company under Articles 2437ter(2) and (4).

Comment

The Court of Milan's approach is questionable for a number of reasons. A drag-along clause necessarily implies a limitation on a minority shareholder's freedom to negotiate the sale price of its participation; however, the minority shareholder must be considered to have unconditionally accepted this limitation in signing the relevant bylaw or shareholders' agreement.

The purpose of such a clause is to allow a majority shareholder to negotiate freely with a third-party acquirer in order to obtain a better price for the sale of the target's entire corporate capital - this also benefits the minority shareholder. Alternatively, the latter can exercise its pre-emption right by acquiring the majority shareholder's participation.

The provision of mandatory criteria for the determination of a sale price would be contrary to the rationale of such a clause and would not help the parties to reach their goals. For example, such criteria could incline a thirdparty acquirer to abandon negotiations if the price thus calculated is too high.

Moreover, if a minority shareholder believes that the enforcement of the drag-along clause has resulted in it being a victim of fraud - as might happen if the majority shareholder and the acquirer agreed on a very high price with the aim of preventing the minority shareholder from exercising its pre-emption right - the minority shareholder is entitled to bring legal action to protect its rights and claim damages against the other parties. The parties' fraudulent behaviour would not affect the validity of the drag-along clause.

Drag-along clauses are increasingly widely used in company bylaws and it is hoped that commentators and case law will analyse the basis of their validity more thoroughly.