

THE DRAG ALONG RIGHT

When an inventor builds a machine, he makes sure that he knows how each of the parts works and how they fit together. The more planning and preparation he puts into the machine, the more smoothly it operates when he switches it on. If the same kind of detailed planning and preparation are put into the legal administration of a company, then selling that company should be a much smoother process. The intention of this series of articles is to assist with that planning by looking at some of the cogs in the machine and providing some insight into what each one does.

This month's cog is the right of one or more shareholders to force the others to join in a sale that they've arranged – usually referred to as a “drag-along”, “bring-along” or simply “drag”. When the company is sold, the buyer will want to be certain that they can acquire all of the shares in the company. A drag is an important cog in the machine – it means the buyer can sign a deal with a small group of shareholders, who can then deliver the entire share capital of the company.

OFFERDRAG LTD.

A sale process without a drag can be complicated, time-consuming and expensive if the company has more than just a few shareholders. A buyer will not want the time or legal costs involved in negotiating a deal with any substantial group of shareholders. Accordingly it is exceedingly rare to see a company of any size make it to a sale process without having a drag inserted into its articles. More often the issue is that the drag that is in the company's articles cannot be used.



One such company was OfferDrag Ltd., whose drag had been drafted on the basis that the potential buyer would first have to make an offer to all of OfferDrag's shareholders – if the majority accepted the offer, the buyer could drag the minority along with them. Due to the makeup of OfferDrag's shareholder base, making that offer would mean engaging an investment bank and publishing a detailed offer document. That sort of process is only suitable for the largest acquisitions, or public company takeovers.

Just as if it had no drag at all, OfferDrag's articles had to be changed. This requires a seventy-five per cent. supermajority at a general meeting, which can be difficult to achieve in itself, and will usually entail a 14 day notice period to call the meeting. Adding or widening a drag right can be particularly problematic - in theory any shareholder who doesn't vote in favour of the new drag could argue that the changes were unfair to them, or that their shares were forcibly taken from them. The potential for such a claim may make a buyer nervous.

In the case of OfferDrag, the articles were successfully changed – the drag itself remained unchanged, and therefore each shareholder was no worse off, but the high administrative hurdle of making a general offer to all shareholders was removed and so the transaction was able to go ahead.

FIXEDPRICE LTD.

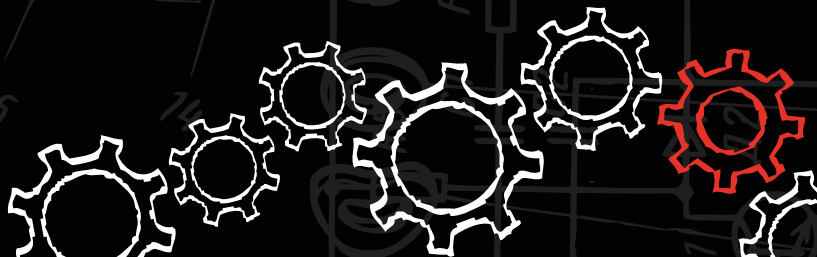
In other circumstances, an inability to drag can be caused by something entirely outside the company's control. When an investor puts up the whole of FixedPrice Ltd.'s C round financing, they wanted the benefit of a drag. Management, as the majority shareholder group, was less keen on giving a substantial minority investor the ability to drag them into a sale.


A compromise was reached – the investor could have the benefit of a drag right, but only if the per-share price in the sale exceeded a fixed amount. The price was high enough that management would be happy to sell if it could be achieved, and the investor had the comfort that when the business hit its projected figures they would be able to sell within three or four years.

The rest is probably obvious by now – the FixedPrice C round took place before 2008. FixedPrice's results have been some way behind their projections, and the price multiples at which businesses in their industry sell have dropped such that FixedPrice would need to outperform its projections by some way in order to hit the per-share valuation set in the drag. Again, the drag has become effectively useless.

The problem here was the use of a fixed price in the drag, which immediately made the drag subject to many variable factors within and outside the business. Even though no-one could have foreseen exactly why it would be needed at the time, giving management a power to lower the trigger price if it saw fit would have been a sensible precaution.

Reducing the fixed price in a drag by amending the company's articles is a more difficult proposition than an amendment like the one made by OfferDrag. As the price is lowered, the investor's power to drag the other shareholders increases. A shareholder





who did not vote for the changes (and is aggrieved at getting dragged at a lower price) may argue that the new drag amounts to the majority forcibly selling the shares of the minority. This becomes more persuasive if a buyer at the new, lower price has been identified and this is what has prompted the changes to the articles. A well-advised buyer in this situation will likely insist on every shareholder voting in favour of the new drag, which is time-consuming and expensive and may not be achievable.

PLANNING AND PREPARATION

As a general rule, at the time of an investment round the investor will ask for changes to the company's articles. This is the time to get the drag correct, or to revisit and polish up an existing drag – the revisions to the articles will be part of a package deal, along with an investment that the company needs, so the existing shareholders can see that accepting or amending a drag obligation is simply part of the commercial reality of accepting an external investment.

Of course it will not be possible to contemplate every circumstance (particularly the external circumstances) in which the drag might need to operate, but as shown in the FixedPrice example it is always worth considering whether any hard numbers that are specified should be subject to revision – and by whom.

Another common problem area for drag rights is that they are often drafted on the assumption that “the investors” or “the management” will always be groups with common interests. If an investor syndicates its investment, or a member of the management is replaced, or if either simply changes their plans for the company, then drag rights which rely on these groups voting together will become useless.

LOTSAOPTIONS LTD.

The stakeholders in LotsaOptions (or their advisers) gave a lot of thought to its drag. LotsaOptions had a good number of employees, and an option scheme to incentivise them. The option scheme had been set up by its accountants firm and, as is common, it contained a provision that if there was a sale of LotsaOptions then all of the options would become exercisable for a period of one year, and then lapse.

Although common, this provision is problematic for drags. Drags are usually provisions of the articles of association, is an agreement among the shareholders of the company. A drag therefore usually only binds shareholders – so while it can give shareholders obligations in respect of the options that they also hold, a drag cannot compel anyone to sell their options if they are not also a shareholder. On exercise of their options each of these optionholders will become a shareholder – but that takes place after the drag sale, so they are not compelled to sell.

Usually the buyer has to make an offer to each optionholder, at the same price per share (less their exercise price), and the deal will not go ahead until they have all accepted. This could be by letter, or by having the optionholders sign up to the share

purchase agreement itself. Either way, completing a sale on this basis in a timely fashion will rely on all of the optionholders being easily contactable and co-operative.

Having already adopted the option scheme before they created their drag, LotsaOptions therefore ensured that the drag would work in their situation. Their drag contained a clause that forced an immediate sale of any shares issued following the exercise of any option that had been outstanding when the drag was exercised, on the same terms as the drag sale.

This worked perfectly – upon exercise of their options each optionholder would become subject to the articles, which would immediately compel him to sell. By taking the time to fit their drag to their situation, the management and investors in LotsaOptions saved themselves considerable time and fees when they conducted their successful exit.

CONCLUSION

A well-drafted drag is a crucial cog in the machine that is an entrepreneur's company. Entrepreneurs should take care to ensure that their drag rights involve a minimal administrative burden, address the main circumstances in which the company may find itself and retain some flexibility in case emergencies occur and the drag cannot be changed in response to them.

Just as importantly, when other parts of the machine are about to change entrepreneurs should also look at this cog – how does this new option scheme, for example, fit with the drag? Making last-minute changes to drags can be problematic and expensive, and sometimes not possible. Keeping them up to date with the changing shape of the company and its shareholder base is the best way to make the machine run smoothly.

