

The Drag Along Clause in the Relationships between Partners and Shareholders in Companies

The drag along clause is an agreement between partners or shareholders in a company, allowing a majority shareholder or partner ("majority shareholder") to force a minority shareholder or partner ("minority shareholder") to transfer, together with the majority shareholder, their stock or shares of the company to a third party at the same price and on the same terms and conditions. The drag along clause enables the majority shareholder to "drag" the minority shareholder into the transfer and thus to limit the opportunities for the minority shareholder to block the transaction.

Drag along arrangements are designed to protect mainly the interests of the majority shareholder as they provide an easier exit and greater flexibility for the majority shareholder in negotiating a package deal for the sale of the entire company to a third party.

Drag along rights are not necessarily in the interest of minority shareholders because they might not be willing to transfer their stock or shares. Even when the majority shareholder has negotiated lucrative terms and conditions for the sale of the stock or shares, minority shareholders may prefer to retain their interest in the capital of the company if, for instance, there are expectations for a higher value in future. For this reason, the most common mechanisms to ensure protection of the minority shareholders' interests are the triggering thresholds and minimum price levels, procedures for the evaluation of the stock or shares, etc. On the other hand, minority shareholders can benefit from the drag along clause since it enables them to sell their stock or shares on the same terms and conditions which apply to majority shareholders and therefore are typically more favourable than the terms and conditions which a minority shareholder could negotiate on its own with a third party.

Typically, their protection is ensured through a tag along clause or co-sale rights, enabling them to join a transaction for the transfer of the stock or shares of the majority shareholder and sell their stock or shares to the third party. In the latter case, the decision whether to join or not is at the free choice of minority shareholders and it does not ensure from dragging them along. Drag along and tag along clauses are most often paired in the Memorandum or Articles of Association of the relevant company or in an additional agreement between the partners/shareholders.

Unlike joint-stock companies in which shares are freely transferrable, unless they are

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restricted, limited liability companies need also a decision of the General Partners' Meeting on the admission of a new partner, which is to be made by a majority of more than three-quarters of the capital. The reason is that although it is a capital company, the limited liability company has a more pronounced personal aspect since the Memorandum of Association is concluded with a view to the personality of the partners and the stock is not freely transferrable. The legal provisions on the need for a decision of the General Meeting by the qualified majority indicated above are imperative and they are not subject to derogation by way of other agreements between partners as set out in the Memorandum of Association or another agreement between them. The absence of a decision of the General Partners' Meeting by the required majority provides grounds for refusal to register the stock in the Companies Register, while the admission of a new partner becomes effective upon its registration in accordance with Article 140(4) of the Commercial Code.

Although the drag along clause is quite common in practice, there exists no legislation on its enforceability. It is an explicit agreement between the partners or shareholders and contracts have the force of law for the parties thereto. Nevertheless, there is no statutory mechanism through which the majority shareholder could force the minority shareholder to join the transfer. The only exception is the provision in the Public Offering of Securities Act that any person who has acquired over 90 percent of the votes in the general meeting of a public company is entitled to register a public offering for the purchase of the shares of the other shareholders.

Therefore the only option left to the majority shareholder is to claim damages against the minority shareholder for non-performance of the agreement which are caused by non-performance of the agreement containing the drag along clause without actually forcing the minority shareholder to transfer its stock or shares. Furthermore, it is possible to negotiate forfeiture in the case of non-performance on part of the minority shareholder to transfer its stock or shares, to conclude a preliminary transfer agreement, to sign explicit powers of attorney to that effect, etc.

Most European countries do not have legislation on drag along rights and therefore they are exercised on the basis of an explicit agreement between the shareholders or partners in the Memorandum or Articles of Association of the company or in a separate agreement. It is

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possible to trigger the drag along clause in the sale of stock or shares, in the merger or acquisition of companies, in stock or share swap deals between companies, in accordance with the terms and conditions of a convertible loan and in other cases, provided that there is an explicit agreement between the parties to do so. For example, in the case of *Cunningham v. Resourceful Land Ltd and others* [2018] EWHC 1185 (Ch) the shareholders had stipulated in their shareholders agreement that if dragged along minority shareholders failed to execute transfers of their shares then the majority shareholders were permitted to execute the transfers on their behalf. The Chancery Division of the High Court of England and Wales upheld the application of the drag along provisions and held that the transfer of the shares by the majority shareholders had been valid.

The absence of explicit drag along and tag along clauses leads to lack of clarity in the relationships between partners and shareholders. Although they could be negotiated, forfeiture clauses would not necessarily guarantee the attainment of the ultimate objective, i.e. the transfer of the stock or shares. The same line of reasoning applies to the option in which the effective implementation of the clause is safeguarded through a preliminary agreement for the transfer of stock or shares because a preliminary agreement will become final and enforceable only in court proceedings and a potential investor would hardly wait for a few years to have the proceedings completed and to obtain an enforceable judgment.