Share Transfer Restrictions and Exit Mechanisms in Shareholders' Agreements

by Jelena Pajic

Shareholders' agreements can be broadly defined as written or unwritten agreements between shareholders whereby the parties set forth reciprocal rights and obligations in addition to those conferred by the law and the constitutional documents of the company. Company law is in fact generally suited for situations in which shareholders are separate from the board of directors and where ownership is relatively dispersed among a large number of shareholders (which is the case of public companies). In contrast, private corporations' shares are usually held by few shareholders, who moreover are directors of the company. Such corporate structure may lead to unbalances in the internal governance of a company and sometimes to abuses to the detriment of minority shareholders. Furthermore, stock in close corporations is usually not listed on an exchange, thus impeding some shareholders (namely, minority shareholders) from easily liquidating their investments in the business.

In such situations, shareholders' agreements become a valuable tool in providing shareholders with additional protection of their diverse rights and interests. These agreements, which do not involve the company's organization structure or modus operandi, may address diverse matters, such as ownership and voting rights, control and management of the company, resolution of disputes which may arise between shareholders, and numerous other issues.

In this article, some arrangements which provide for transfer restrictions of shares and others which regulate the circumstances under which shareholders may dispose of all or part of their shares will be analyzed and discussed. Among private companies, shareholders often want to restrict transfers of shares by other shareholders for a number of reasons. For example, they might be concerned about the corporate structure changing radically, allowing "undesirable" parties to become shareholders and thereby gaining access to confidential information concerning the company.

Another concern addressed by shareholders' agreements is the protection of minority shareholder interests, who do not share the same bargaining power of majority shareholders as far as share transfer is concerned. These kinds of risks are addressed by specific arrangements between shareholders, which have become of widespread use in corporate reality.

Call Options and Put Options

Call and put options are liquidity provisions commonly found in shareholders agreements, which constitute unilateral options or rights to purchase (in the case of call options) and sell (in the case of put options) shares. A shareholders agreement may provide that put options and call options may be exercised at any time or only upon the occurrence of a specified triggering event.

Call Options

A call option is a right, but not an obligation, to buy. A call option is an agreement that provides one of the parties with a unilateral right to acquire an asset (the underlying) from the counterparty at a specific time (expiration date) and at a previously specified price or a price ascertainable by reference to a pre-agreed formula (strike price). It must be noted that different assets may constitute the underlying, namely commodities, securities, currencies, etc. In this article we will take into consideration options relating to shares.

Put Options

If a call is a right to buy, a put is an option to sell. More specifically, a put option right is an option ex-

ercisable by a shareholder to unilaterally require another party (usually another shareholder, group of shareholders or the corporation itself) to purchase his or her shares (the underlying), at a previously determined price or determinable according to a pre-agreed formula (strike price) and at a specific time (expiration date). Therefore, if the put option holder decides to sell its stakes, the counterparty is obliged to buy at the agreed upon price.

Contexts in which Put and Call Options are Typically Used

Put and call options are typically used when special circumstances arise, which are fundamental to the relationship among shareholders and which may affect the basis of their original agreement.

Among others, this might be the case of events such as death, temporary or permanent disability, insolvency, breach of shareholders agreements, and cessation of employment of employees holding a small number of shares, matrimonial property claims and other special circumstances (e.g. the loss of a professional certification).

In some cases, such as in the case of non-performance of a duty by one shareholder, the call option serves as a penalty, as it allows the other shareholders to buy out the shares of the faulty shareholder, thus excluding him from the social structure of the company.

Puts and calls are also common among shareholders selling only part of their holdings. In such cases, they usually negotiate a put option with the buyer concerning the remaining shareholdings in the company. Through this arrangement they ensure from being "trapped" in the company with only a minority shareholding: if need be, they can exercise their put right and dismiss their shares easily and at a better sale price than they would otherwise be able to negotiate with third parties. In mergers and acquisitions transactions this has become a routine arrangement.

On the other hand, buyers of minority shareholdings very often deem it crucial to negotiate put and call options as ancillary clauses of the transaction. This is common when buying shares in non-listed companies that have a rather stable shareholders' structure. In such cases puts and calls allow buyers, respectively, to sell the shares back or to buy other shares in order to hold a more significant percentage of the share capital. In some cases, shareholders other than the one selling the shares may enter these option arrangements.

Tag-Along Rights

Tag-along provisions are most common in joint-venture or private equity agreements. Tag-along rights, also known as co-sale rights, are typically allocated in favor of minority shareholders against control shareholders with selling power.

A tag-along clause typically requires that shareholders intending to sell their shares to an outside investor offer to the other shareholders the opportunity to take part in the sale. Technically, tag- along rights represent a put option right, where the price agreed upon with the third party acts as an endogenous strike price. In other words, the tag-along right gives its holder the right to sell a pro rata portion of his shares to the same purchaser at the same price and on the same terms and conditions.

To this end, the selling shareholder must notify the shareholder entitled to the tag-along right of the proposed sale, after which the latter will have a period of time to elect whether to exercise his tag-along right by joining in the transaction. If so, the selling shareholder will have to negotiate for both parties in order to obtain from the purchaser a commitment to purchase both shareholdings. Only in the absence of a request of "co-sale" will the selling shareholder be released from any duty towards the other shareholders and be free to sell his holding.

The provision under discussion is paramount in the protection of non-controlling owners' investment. More specifically, the reasons underlying such clauses are twofold, namely (i) to protect minority shareholders from parts of the company being sold to outsiders capable of reducing the value of the firm and (ii) to allow minority shareholders to benefit from and share in any control premium that may be available on the sale of a controlling ownership position.

Through the tag-along clause, these goals can be effectively achieved as the controlling shareholders are forced to offer the other shareholders the chance to participate in the sale and share the control premium (which can be realized only when selling dominant or controlling positions). It follows that

tag along clauses prevent the most vulnerable parties in a company from being excluded from a value-increasing sale of the holdings.

Drag-Along Rights

A drag-along provision attributes to one or more shareholders the right to force all other shareholders to jointly sell their shares to a third party at the same price and upon the same terms and conditions.

Technically, drag along rights constitute a form of call option on the shares of other shareholders with an endogenously determined strike price (that is a price agreed upon with a third party).

In a nutshell, this mechanism ensures that if a specified percentage of shareholders agree to sell their shares, they can compel the others to sell as well, thereby ensuring that a prospective purchaser can acquire 100% of a company.

Drag-along arrangements are usually associated with a clause providing for a call option on the shares of the other shareholders. The call option right comes into play if, and when, the other shareholders refuse to honor the joint sale commitment.

By exercising his right to buy the shares of the continuing shareholders, the selling shareholder can overcome their opportunistic behavior by compelling them to sell their shares in accordance with the call option. Despite their intention to remain in the company alone, the other shareholders are thus forced out.

The provision under discussion normally works to the benefit of majority shareholders, who are enabled to expand the scope of their proposed sale by including the holdings of the other shareholders. This helps to overcome blocking or troublesome minority shareholders, by preventing them from delaying or stopping sale transactions, such as mergers or sales of substantially all of the assets of the company.

Moreover, by selling a larger stake of the company than they own, majority shareholders are enabled to realize a higher sale price. Behind this clause lies the rationale that a business is more likely to be sold in its entirety or at least to an extent that provides the buyer with sufficient shares to gain an effective control of it.

Right of First Refusal

The "rights of first refusal" provision is one of the most common provisions in the incorporating documents of closely-held companies or in shareholders' agreements. The aim of such provision is to ensure that the company and/or the shareholders are given the opportunity to purchase any shares that any shareholders desire to sell. In fact, by adopting this mechanism, shareholders promise that they will sell their shares only after negotiating a price with a third party and afterwards offering the shares at that price to the remaining shareholders. In the typical right of first refusal scheme, there are three parties involved: the owner and right holder who have contracted for the grant of the right and one or more potential third-party buyers. The preemption right granted to the other shareholders allows them to step into the shoes of the potential buyer and make the purchase. To this end, it must be noted, the holder of the right must accept every term set forth in the third party's bona fide purchase offer.

The model explained above is usually referred to as "hard" right of first refusal, by comparison to the "soft" right of first refusal. The "soft" right of first refusal provides that a shareholder willing to sell its shares must first deliver a notice to the other shareholders offering to sell all, but not less than all, of such shares to them on a proportionate basis on specific terms. In both cases, if the other shareholders do not exercise the right to purchase the shares offered to them, the selling shareholder will be free to sell to third-party purchasers in a prescribed period of time. If such a transaction does not occur within the said time, the right of first refusal is revived. Obviously, it is more likely that a soft right of first refusal will be granted, as knowledge that the other shareholders or the corporation will have a right to match a third-party offer may discourage potential purchasers from making an offer.

Such rights of first refusal are common, albeit with varying details, in commercial contracts relating to assets ranging from gas stations to oil pipelines, from shares of stock to livestock. Corporate securities and, in particular, shares held by the owners of close corporations are among the most important subjects of rights of first refusal. Co-ventures often enter into agreements in which each participant grants and receives first refusal rights to and from the others. Moreover, the corporation may also hold rights in addition to or instead of the participants.

Although often associated with options, the right of first refusal is not a true option. Unlike the holder of a call option, who has a unilateral right to trigger the purchase at the option price during the term of the option, the holder of the first refusal right has only an option to purchase contingent upon the other party's resolution to sell.

In this respect, it is important to investigate the economic reality of the instruments adopted by the parties beyond the labels applied by them. Rights of first refusal should not be confused with the right of first offer as well: in the latter, the selling shareholder is required to first solicit offers form the other shareholders, and only on condition that he can obtain a more profitable offer from a third party will he be allowed to sell the shares to this latter.

The mechanism here addressed provides shareholders with a power to control the identity of their future co-shareholders. By exercising this right, the continuing shareholders prevent the withdrawing investor's holding from being bought by investors who do not intend to actively join in the management of the business or those who could squeeze-out minority investors.

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