

DRAG-ALONG AND TAG-ALONG RIGHTS IN PRIVATE EQUITY TRANSACTIONS - ARAOZ & RUEDA

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Private equity (PE) investments will typically confer on the investor certain special rights to control in a certain way how transfers of shares in the target company may/will occur. The primary purpose of such provisions is to protect both the value and the liquidity of its investment in the event of any projected transaction involving the share capital of the target company or the composition of its shareholding.

Francisco Aldavero, socio de Araoz & Rueda y especialista en capital riesgo, subraya en este artículo la importancia de dos herramientas habituales e importantes en las inversiones realizadas por entidades de capital riesgo: los derechos de drag-along (arrastre) y de tag-along (seguimiento). El fin principal de estas disposiciones es proteger el valor y la liquidez de una inversión, especialmente cuando el fondo de capital riesgo está preparando su salida del accionariado. Los derechos de tag-along se refieren a la prerrogativa de un accionista de vender a un tercero sus acciones al mismo precio que a los otros accionistas. Al contrario, drag-along significa que los accionistas mayoritarios tienen la posibilidad de forzar a un accionista minoritario no dispuesto a vender a que traspase su

participación.

Such control over transfer of shares implies that, as a general rule, traditional shareholders rights on transfer of shares, such as rights of first refusal, need to be recognised to the management after deep consideration of the particularities of each transaction, as they may jeopardise an exit opportunity for the PE investor.

As a general approach, management should not be entitled to exercise its rights of first refusal if a PE investor wishes to sell a minority interest in the company to a non-competitor or financial investor or in case the PE firm intends to sell its majority interest in the company to a third party, irrespective of such third party being a competitor or not, and provided that management may exercise tag-along rights. On the other hand, a PE investor should always expect to obtain tag-along rights (especially in minority investments) and drag-along rights (both in minority and majority investments).

Tag-along rights are appealing to PE houses when they hold a minority stake in the company and do not seek to become a majority shareholder. Such rights allow them to co-sell their stake, when the majority shareholder or the key directors/officers decide to sell theirs, without being obliged to stay in the company with a new third party or without the key individuals who manage (and/or control) the company. These rights are of a key importance in case that, for any reason, the PE firm is not prepared to exercise its rights of first refusal.

When a shareholder seeks to sell its interest to a third party, tag-along rights enable a PE investor to co-sell its stake in the company under the same conditions as the selling shareholder. It should be noted that tag-along rights may not be registered with the Commercial Registry, and therefore, the co-sale right may not be enforceable vis-à-vis third parties. As a matter of example, section 30.2 of Act 2/1995 declares null and void any provision in the articles of association of the target company that impose a selling shareholder to sell a different number of shares than those offered.

Drag-along rights are useful to implement divestments, by enabling one or several shareholders to compel the remaining shareholders to join him/them in the exit and sell their shares to the prospective buyer under the same conditions as the selling shareholder(s). This right prevents the possible refusal to sale by the remaining shareholders, which could continuously hold back the transaction in detriment of the rest of shareholders.

However, drag-along rights are also used to protect PE investors who acquire minority investments and need to have a clear exit to sell the shares to third parties, at the time the PE firm considers it convenient on the basis of its expected returns or the situation of the market. In such cases, shareholders may agree a joint-exit clause by previously laying out equitable terms and conditions that shall apply to the exit of the shareholders.

To ensure the enforceability of these agreements in cases of disputes, it is advisable to always consider their inclusion in the Articles of Association. However, further to the protection provided by shareholders agreements and duly registered Articles of Association, these rights may be reinforced through other contractual agreements, such as irrevocable powers of attorney which grant in favour of the PE firm the power to sell shares of the remaining shareholder; and call/put options.

Francisco Aldavero is a private equity specialist and a partner at Araoz & Rueda. He can be contacted via aldavero@araozyrueda.com.