People like control and certainty. Many business owners create agreements to delineate the parameters of their relationships.

In corporations with relatively few owners, this often takes the form of shareholder agreements that govern the sale and transferability of shares and set forth other provisions regulating the shareholders' relationship. One of the provisions increasingly included in shareholder agreements is a "drag-along" right.

A drag-along right allows a majority shareholder[1] to force the other shareholders to sell their shares for the same price and on the same terms as the majority shareholder. This often allows the controlling shareholder to obtain a higher price for the stock than if he sold only his portion of the company. Some drag-along clauses are drafted so the controlling shareholder can require minority shareholders to vote their shares to approve a sale of substantially all the assets of a company or a merger.

Let's look at a simple example. Assume Joe owns 80 percent of ABC Corp. and Mary owns 20 percent. Joe wants to sell his stock to Susan. However, Susan prefers to own 100 percent of the stock because (1) she doesn't want to go into business with Mary, whom she doesn't know, (2) she doesn't want to account to Mary for her actions, (3) she wants to avoid potential shareholder disputes, and (4) she wants to maximize her ability to sell to a later purchaser. For these reasons, if Susan can buy all of the ABC Corp. stock, she will pay more per share than if she can only buy less than all of the stock. If the ABC Corp. shareholder agreement contains an enforceable drag-along right, Joe could force Mary to sell her shares to Susan.

So, are drag-along rights enforceable in Illinois? To answer this question, two other questions must be answered affirmatively: (1) Are restrictions on the purchase and sale of stock allowed in shareholder agreements? (2) If so, are drag-along rights enforceable buy-sell provisions in shareholder agreements?

Are buy-sell restrictions allowed in shareholder agreements?

The Illinois Corporate Code ("Code") provides that restrictions on the transfer of stock may be imposed by an agreement between shareholders.[2] The Code also provides that shareholder agreements are allowed so long as they relate

1. Technically, a drag-along right could be granted to any shareholder and not only the majority; however, it is typically a mechanism used by a majority owner to force the minority owners to sell their shares.
2. 805 ILCS 5/6.55(b).

Markus May is a business attorney with Eckhart Kolak LLC in Chicago. He is a past chair of the ISBA Business and Securities Law Section Council. *He thanks fellow members of the Institute of Illinois Business Law for their input.*

Shareholder Drag-Along Rights in Illinois

Drag-along rights let majority shareholders force others to sell at the same price and on the same terms, thereby making the shares more valuable. The author argues they are enforceable in Illinois and offers a checklist for drafting drag-along provisions.

By Markus May

to the management of a corporation, "no fraud or apparent injury to the public or creditors is present, and no clearly prohibitory statutory language is violated."[3] Further, the common law, which is incorporated into the Code,[4] provides that shareholder agreements are enforceable contracts between shareholders so long as they are "not dishonest, violative of the rights of others, or in contravention of public policy."[5]

Therefore, buy-sell restrictions are allowed in shareholder agreements, so long as they do not violate the law, injure the public or creditors, or commit a fraud.[6] This leads us to the second question.

Are drag-along rights enforceable buy-sell provisions?

The Code provides: "A restriction on the transfer of securities of a corporation is permitted by this Section if it: [constitutes one of four situations – none of which specifically includes drag-along rights]...."[7] Because the specifically enumerated sections of this section of the Code do not provide for drag-along rights, some other authority is required for drag-along rights to be enforceable in Illinois. This authority is found in section 6.55(e) of the Code, which provides as follows: "*Any other lawful restriction on transfer or registration of transfer of securities is permitted by this Section.*"[8]

A drag-along right allows a majority shareholder to force others to sell their shares at his price and terms, which often yields a higher price for the stock.

Section 6.55 of the Code is based upon Delaware Corporate Code Section 202, and subsections (c) and (e) are basically the same as the Delaware provisions that existed prior to 1999. However, in 1999 Delaware amended subsection (c) to specifically provide that drag-along rights are enforceable.[9]

Initially, there is a question whether 6.55(e) allows a shareholder agreement to include drag-along rights or whether

3. 805 ILCS 5/7.71(a).
4. 805 ILCS 5/7.71(e).
5. *Galler v. Galler*, 32 Ill.2d 16, 23-24, 203 N.E.2d 577, 582 (1965); *Rench v. Leihser*, 139 Ill.App.3d 889, 890-891, 487 N.E.2d 1201, 1201 (5th Dist. 1986). Further, legal treatises and commentators routinely state shareholder agreements can place restrictions on the purchase and sale of stock. *See* D. Kendall, *Choice of Entity Issues and Corporations*, Sections 5.21 – 5.28, Inst. of Legal Ed. Ill. Bus. Law (2011).
6. There is an argument that "management of a corporation" limits subsection 7.71(a) shareholder agreements to actions which could be taken by the board of directors because the affairs of a corporation are generally managed by its board of directors. 805 ILCS 5/8.05 and *In re High-Low Tank Car Service Stations, Inc.*, 254 F.2d 363, 364 (7th Cir. Ill. 1958). However, as 6.55(b) and the common law both allow buy-sell restrictions on the sale of stock, 7.71(a) should not be construed to preclude such restrictions. Further, the Illinois Supreme Court has recognized courts have relaxed their attitudes concerning strict statutory compliance and will allow certain behaviors in order to allow common business practice. *Galler*, 32 Ill.2d at 28-30, 203 N.E.2d at 584-585.
7. 805 ILCS 5/6.55(c).
8. 805 ILCS 5/6.55(e).
9. 8 Del. C. § 202(c)(4) provides a restriction is allowed if it: "Obligates the holder of the restricted securities to sell or transfer an amount of restricted securities to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing, or causes or results in the automatic sale or transfer of an amount of restricted securities to the corporation or to any other holders of securities of the corporation or to any other person or to any combination of the foregoing."

the listing of certain situations in 6.55(c) somehow limits adding drag-along rights to shareholder agreements. Illinois courts have not specifically addressed this question. However, the plain language of 6.55(e) indicates that "any other lawful restriction on transfer" is allowed, in addition to the four restrictions in 6.55(c).[10]

Therefore, if drag-along rights are an "other lawful restriction" under common law, they will be enforceable. Both Illinois common law as well as Delaware common law are instructive in interpreting Section 6.55(e).

If an Illinois court were asked to enforce a drag-along provision, the available evidence suggests it would do so.

Illinois common law: reasonable drag-along provisions should be enforceable

No Illinois courts have interpreted what constitutes an "other lawful restriction on transfer" of stock under section 6.55(e). Therefore, a court would need to determine the types of stock restrictions allowed under Illinois common law to determine if drag-along rights should be enforceable.

In *Galler*, the Illinois Supreme Court ruled that where no injury to a minority interest appears, no fraud or injury to the public is present, and no statute is violated, "we can see no valid reason for precluding the parties from reaching any arrangements concerning the management of the corporation which are agreeable to all."[11] Thus, a shareholder agreement that had a purpose of providing income for shareholder families and which had a buy-sell provision between shareholders was valid.[12]

The validity of the buy-sell provisions was not explicitly ruled upon in *Galler*; rather, the court presumed the buy-sell provision was valid. *Galler* was decided before the Code provisions were enacted, but shows a strong policy in Illinois to enforce shareholder agreements and the private right to contract so long as public policy is not violated or third parties are not harmed. Thus, under Illinois common law, reasonable restrictions which do not violate law or public policy are enforceable.[13]

Drag-along rights are basically buy-sell agreements between shareholders that mandate the sale of stock in certain situations. Drag-along rights do not violate third party rights, as they are entered into between consenting shareholders.[14] There is no law against such agreements and they do not violate any public policy. Therefore, if an Illinois court were to apply Illinois common law to determine whether drag-along rights constitute an "other lawful restriction on transfer," typical drag-along rights should be enforceable.

Note, however, if drag-along rights are more expansive and require shareholders to vote their shares to approve the sale of substantially all the assets of corporation or a merger, then a shareholder may be entitled to dissenter's rights.[15] Illinois law is unclear as to whether dissenter's rights can be waived in a shareholder agreement (there is no case on point), but in drafting such provisions, the attorney would be well advised to couch them as "voting agreements" which are specifically enforceable in equity under Illinois law and to specifically reference the knowing waiver of dissenter's rights.[16]

The Delaware standard: stock transfer restrictions okay if "reasonable"

Unlike Illinois courts, the Chancery Court of Delaware has expressly ruled on the meaning of "any other lawful restriction." As the Illinois statute is based on the Delaware statute, an Illinois court would likely examine Delaware law and, absent a good reason, interpret the language the same way as the Delaware courts.

A Delaware court has held that an "other lawful restriction" in subsection (e) is valid if it was "reasonable."[17] This includes being "reasonably necessary to advance the corporation's welfare or attain the objectives set forth in the corporate charter and determining this requires balancing the policies served by the restrictions against the traditional judicial policy favoring the free transfer of securities."[18]

Thus, requiring a shareholder to offer a corporation a first right to purchase stock was allowed because maintaining stock ownership among employees was reasonable.[19] Refusal rights that allow shareholders to maintain their proportionate interest in a company are also considered to be reasonable restrictions.[20]

However, it is not reasonable to require the sale of stock merely so the board can choose shareholders who are agreeable to the board.[21] Note that Delaware courts are reluctant to invalidate stock restrictions because they are unreasonable and they are deferential to decisions of shareholders to place restrictions on stock.[22] Therefore, in Delaware, "any other lawful restriction" will be considered "reasonable" if the restrictions are "reasonable to achieve a legitimate corporate purpose."[23]

The legitimate-corporate-purpose test: law from other jurisdictions

What do the cases and statutes say about whether drag-along rights are rea-

10. Delaware courts have held the 6.55(e) language allows shareholders to create other restrictions in shareholder agreements. *See Capital Group Cos. v. Armour*, 2005 Del. Ch. LEXIS 38, at *22-23 (Mar. 15, 2005), which states that "any form of restriction other than those enumerated in subsection (c) is also permissible...." (citing *Grynberg v. Burke*, 378 A.2d 139 (Del. Ch. 1977), *rev'd* on other grounds, *Oceanic Exploration Co. v. Grynberg*, 428 A.2d 1, 8 (Del. 1981)); *Capano v. Wilmington Country Club*, 2001 Del. Ch. LEXIS 127 (Oct. 31, 2001). There is no reason to believe Illinois courts would not enforce the plain language of the statute and follow suit.

11. *Galler*, 32 Ill. 2d at 30, 203 N.E.2d at 585.

12. *Galler*, 45 Ill.App.2d 452, 196 N.E.2d 5 (1st Dist. 1964).

13. *Rench*, 139 Ill.App.3d at 890-891, 487 N.E.2d at 1202.

14. This presumes there is no fraud or other sharp dealing involved and the agreement is entered into between freely consenting shareholders.

15. 805 ILCS 5/11.65. "The goals of dissenters' rights statutes today are to protect minority shareholders from majority overreaching, self-dealing, and oppressive conduct in an attempt to eliminate a minority shareholder at a price below fair value, or in an attempt to transfer power to the majority." *Brynwood Company v. Schweisberger*, 393 Ill.App.3d 339, 356, 913 N.E.2d 150, 165 (2d Dist. 2009). However, a dissenting shareholder is only entitled to fair value which would typically include discounts and costs of sale and therefore the shareholder would probably not receive as much as if the shareholder is "dragged-along" in a sale.

16. 805 ILCS 5/7.70. For additional discussion on dissenter's rights, see *"Towing the Line: An Analysis of Drag-Along Rights Under the Michigan Business Corporation Act"*, K. T. Block & J. S. Berg, 28:3 Mich. Bus. L. J., 21-22 (Fall 2008).

17. *Capano*, 2001 Del. Ch. LEXIS 127, at *23.

18. *Id.* at *24.

19. *Id.*

20. *Capital Group Cos.*, 2005 Del. Ch. LEXIS 38, at *23.

21. *Capano*, 2001 Del. Ch. LEXIS 127, at *23.

22. *Capital Group Cos.*, 2005 Del. Ch. LEXIS 38, at *31, 33.

23. *Id.* at *35.

sonable to achieve a legitimate corporate purpose? Neither the Illinois Corporate Code nor Illinois case law specifically reference drag-along rights. Only 18 cases nationwide have referenced "drag-along" rights in the corporate context and all 18 *assumed* drag-along rights are enforceable.[24] There was *no* case in which a party claimed drag-along rights are unenforceable.

For a court to assume drag-along rights clauses are enforceable is a good indication it believes there is a reasonable corporate purpose for such clauses. In fact, one court has stated drag-along rights are "customary" in certain shareholder agreements.[25]

Delaware's addition to its corporate code in 1999 of a specific provision allowing drag-along rights can also be seen as evidence that such clauses are viewed as being for a valid corporate purpose. If they were not, the Delaware legislature would not have added them to the statute.[26]

Additionally, in 2010 the Corporation Law Committee of the New York City Bar Association published an article on shareholder provisions which, after discussing the lack of case law enforcing drag-along rights, provided a number of drafting considerations with respect to drag-along rights.[27] Presumably, the Corporation Law Committee believed drag-along rights are reasonable to achieve a legitimate corporate purpose or it would not have created drafting considerations.

Some legitimate corporate purposes for drag-along rights include (1) allowing the controlling shareholder to maximize price and effectively sell a larger portion of the company than it owns, (2) facilitating corporate governance by decreasing potential dissension between existing minority shareholders and a new owner, and (3) facilitating the sale of a company's stock as buyers are more likely to buy when they own a greater amount (especially 100 percent) of a company. Typically, minority shareholders are protected in the purchase price because their shares are purchased for the same price and on the same terms as the controlling shareholder's shares. This generally provides the minority shareholders with a greater price than if they were selling the stock on their own.

A corporation is an entity distinct from its owners. Arguably, allowing a buyer to obtain ownership of the company without needing to deal with minority shareholders is in a corporation's best interests. If there are disgruntled minority shareholders, there can be distractions and added expense to the company. Therefore, corporations may operate more efficiently if they can avoid disputes with minority shareholders.

In sum, the arguments that drag-along rights are reasonable to achieve a legitimate corporate purpose are that they (1)

24. *See Minn. Invco of RSA # 7, Inc. v. Midwest Wireless Holdings, LLC*, 903 A.2d 786, 794-795 (Del. Ch. 2006) in which the court ruled a majority shareholder could enforce drag-along rights which conflicted with a minority shareholder's right of first refusal.

25. *Psilos Group Ptnrs, L.P. v. Towerbrook Investors L.P.*, 2007 Del. Ch. LEXIS 8, at *10 (Jan. 17, 2007).

26. It could also be argued the legislature's decision to create such a clause shows the clause is necessary.

27. Report, Corporation Law Committee, Association of the Bar of the City of New York, *"The Enforceability and Effectiveness of Typical Shareholders Agreement Provisions,"* 65:4 The Business Lawyer, pp.1153 *ff* (August 2010).

are often assumed to be enforceable by courts; (2) are specifically provided for in Delaware's statute; (3) are often used in certain shareholder agreements; (4) are discussed as though they should be valid in scholarly journals; (5) facilitate higher prices for all shareholders; (6) help eliminate dissension among future shareholders; (7) can eliminate corporate distractions, improve efficiency, and increase profit; (8) help shareholders to freely contract between themselves as they see fit in order to regulate future ownership of the corporation; and (9) facilitate the sale of stock.

There appears to be nothing in the law to indicate why properly drafted drag-along rights are not reasonable to achieve a legitimate corporate purpose. Therefore, lawyers arguing for their enforceability are well-positioned for success.

Drafting checklist

A drag-along clause can be a relatively short and simple statement in a shareholder agreement providing that the minority shareholders agree to sell their shares for the same price and on the same terms as the controlling shareholder. Of course, the clause can also be much more detailed and address a number of related issues. Here are factors to consider in drafting a drag-along provision.[28]

1. Can the drag-along right be enforced for less than 100 percent of the company stock?
2. When can the drag-along right be triggered? Can it be triggered at any time or only when certain financial or timing standards are met?
3. Should the dragged-along shareholders make representations and warranties?
4. Should the dragged-along shareholders indemnify the buyer?
5. Do minority shareholders pay a pro-rata share for breaches of representations and warranties and other agreements? Is there a "not to exceed" amount or joint and several liability or no liability for minority shareholders?
6. Should the dragged-along shareholders make any post-closing covenants, e.g., noncompetition covenants?
7. Are dragged-along shareholders subject to any post-closing purchase price adjustments?
8. Are there any escrow or hold-back requirements that apply to the dragged-along shareholders?
9. If there is a seller note, do the dragged-along shareholders get paid out early or share pro-rata and have to wait to receive full purchase price?
10. If there is a contingent sales price (e.g., earnout), how/when is this distributed?
11. To what other extent are dragged-along shareholders necessary parties to the contract, e.g., do they consent to allowing equitable and injunctive relief to issue against them?
12. Is there a minimum sales price that would allow the drag-along rights to be enforced? For example, if the price is too low, can the drag-along rights not be enforced? Note this may implicate fiduciary duties for shareholders and trustees as well as possible fraudulent conveyance law.
13. What happens if stock options exist or can be exercised while the sale is pending? Should such options lapse if not exercised or should there be a mandatory sale of the options to purchaser?
14. Should the clause provide that shareholders agree to vote their shares to approve any matter that must be submitted to shareholders to complete the proposed sale?
15. Do minority shareholders have to pay a pro-rata share of transaction expenses?
16. Ensure all shareholders deliver certificates prior to closing with a stock power to deliver to purchaser.
17. Identify all types of transactions to which the drag-along right may apply. Should it include merger, share exchange, sale, lease, or exchange of all or substantially all assets of the corporation? This may not be necessary if the controlling shareholder controls enough shares to approve such transactions without dragging along the minority shareholders.
18. If there is an expansive drag-along that also requires voting of shares in the event of a merger or sale of assets, dissenter's rights research should be updated. Consider adding a specific waiver of dissenter's rights, a specific voting agreement, and proxies in order to later argue dissenter's rights were freely and knowingly waived.
19. Should the minority shareholders grant a power of attorney so the drag-along right can be enforced by the controlling shareholder and by the secretary of the corporation if a minority shareholder is uncooperative?
20. If there are multiple classes of stock, review how the language will affect the various classes and consider if different classes should be treated differently.
21. How detailed should the clause be with respect to when the minority shareholders are to transfer the shares (before or at closing, escrow language, etc.)?

Conclusion

Until the Illinois Supreme Court rules, or the statute is changed to specifically allow drag-along rights in shareholder agreements, there is not a 100 percent guarantee drag-along rights are enforceable. However, if an Illinois court were asked to rule on the enforceability of a drag-along provision, everything points in the direction of the court finding the provision enforceable, provided no fraud or apparent injury to the public or creditors is present. Of course, this presumes the controlling shareholder is acting fairly and not violating any fiduciary duties to the minority shareholders.[29] ■

28. *Id.* at 1184-1186; Block et al., *supra* note 16, at 21.
29. *Cafcas v. De Haan & Richter, P.C.*, 699 F. Supp. 679 (N.D. Ill. 1988).