

# *Towing the Line: An Analysis of Drag-Along Rights Under the Michigan Business Corporation Act*

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## **Introduction**

Agreements between shareholders<sup>1</sup> are commonly used to define the relationship between shareholders, pre-determine the outcome when disputes arise, restrict a shareholder's ability to transfer his or her stock, determine the value of shares on transfer, and attempt to avoid problems that may arise in closely held corporations. Operating agreements and other agreements among members of a limited liability company typically address these same issues. It has become increasingly common for such agreements to incorporate "drag-along" rights and/or "tag-along" rights provisions, especially when one or more of the shareholders are private equity investors. These provisions are frequently referred to as "co-sale" rights. Co-sale rights give a shareholder the right to join in the sale of shares ("tag-along") or provide a shareholder, typically the majority shareholder or a shareholder owning the largest percentage of shares outstanding, in either case for purposes of this article the "Controlling Shareholder," the right to require other shareholders to vote in favor of a transaction and join in the sale of such shareholder's stock ("drag-along").

This article briefly discusses drag-along rights and essential issues that should be considered when drafting drag-along provisions. This article also discusses the validity of drag-along provisions in light of applicable Michigan Business Corporation Act (MBCA) provisions that govern shareholder agreements, voting agreements, and dissenters' rights.

## **Drag-Along Rights**

### *What Are They?*

Drag-along rights provisions typically provide that if a controlling shareholder desires to effectuate the sale of all the outstanding shares of the corporation, a merger, or sale of substantially all of the corporation's assets,

the Controlling Shareholder has the right to require the other shareholders to vote in favor of the transaction and, in the case of a stock sale, sell their shares.<sup>2</sup> The Controlling Shareholder must typically give the minority shareholder the same price, terms, and conditions as those negotiated by the Controlling Shareholder.<sup>3</sup>

Use of drag-along rights should be considered when forming corporations and other entities. A drag-along provision enables a controlling shareholder who wants to sell its shares to a third party to force all other shareholders of the company to sell all of their shares to that same purchaser on similar terms and conditions. This assures that the Controlling Shareholder will control any transaction involving the entity, the prospective purchaser will acquire complete control of the company, and the selling minority shareholders will not receive a price discounted for lack of marketability.<sup>4</sup> Drag-along provisions also give the controlling shareholder the ability to maintain greater liquidity of the shareholder's investment.<sup>5</sup> By forcing the other shareholders to sell as well, the Controlling Shareholder is more likely to find a purchaser for the shares because it can guarantee the purchaser 100 percent ownership of the company.

Drag-along provisions provide a Controlling Shareholder the ability to effectuate a transaction even when it owns less than a majority of the shares by requiring other shareholders to vote in favor of the transaction. Shareholders owning a majority of the stock (or such higher percentage as may be required by supermajority voting provisions in the articles, bylaws, or voting agreement) have the power under the MBCA to approve a merger, sale of all or substantially all of the assets, or a statutory share exchange transaction.<sup>6</sup> Each of these forms of acquisition transactions will create dissenters' rights for dissenting shareholders, unless a generally applicable exemption is available.<sup>7</sup> One of the purposes of a drag-along provision is to

provide a Controlling Shareholder with the right to effect a disposition of a corporation's shares without triggering dissenters' rights.

### *Drafting Considerations*

The exercise of a drag-along right raises issues regarding the terms on which a shareholder may require a dragged-along shareholder to participate in the sale.<sup>8</sup> A drag-along right may have little value absent a shareholder's ability to require the other shareholders to do more than just vote in favor of the proposed transaction.<sup>9</sup> A dragged-along shareholder may not be willing to make representations and warranties, indemnify the buyer, or make post-closing covenants.<sup>10</sup> The drafter of such provisions, therefore, should address the extent to which the minority shareholder who is being dragged-along will be required to participate in the sale. Although a drag-along provision can be deceptively brief, one should consider the following issues when drafting a drag-along provision:<sup>11</sup>

- Stating when the drag-along right may be triggered. For example, include a timing limitation, a guaranteed return or business performance threshold, or a timing plus performance trigger.
- Identifying all types of transactions (merger, share exchange, or sale or exchange of all or substantially all assets of corporation) that might trigger the drag-along right.
- Defining and/or limiting the representations, warranties, or covenants, including non-competition covenants, which the dragged-along shareholders must make to a future purchaser.
- Identifying any requirements of the dragged-along shareholder for indemnification to the buyer or the other sellers (contribution obligations) and any escrow or holdback of payments to which the dragged-along shareholder consents.
- Consenting to equitable relief and irreparable harm if litigation becomes necessary to enforce the drag-along rights.
- Specifying whether the pro-rata price per share should be no less than a defined amount, i.e., the higher of (i) the shareholders' equity investment, or (ii) book value, fair market value, specified formula, etc.
- Requiring the dragged-along shareholder to take such actions as reasonably

required by the seller, such as: (i) voting shares in favor of the drag-along sale (or consent), (ii) executing any purchase, merger, or other agreement entered into with the purchaser, (iii) requiring a director nominated by the shareholder or a shareholder who is also a director to vote in favor of the transaction,<sup>12</sup> and (iv) refraining from exercising any dissenters' or similar appraisal rights to such transaction.

- Providing for an irrevocable proxy to vote shares in accordance with the agreement if the shareholders do not vote or refuse to vote in favor of the sale.
- Requiring that consideration be limited to cash (or a certain percentage of the consideration be in cash).
- Requiring a fairness opinion from an independent investment bank.<sup>13</sup>

Additional or alternative conditions to the exercise of drag-along rights may be negotiated.

### **Applicable MBCA Provisions**

#### *In General*

When drafting drag-along provisions involving shares of a corporation, the drafter should consider the impact of the MBCA on the enforceability of such provisions. MBCA provisions to consider include dissenters' rights provisions, voting agreement provisions, and the Section 488 shareholders agreement provisions.

#### *Dissenters' Rights*

A drag-along provision may be challenged on the grounds that a shareholder cannot waive statutory dissenters' rights. Indeed, there has been some question as to whether "drag-along" rights are enforceable.<sup>14</sup> The exercise of drag-along rights may be rendered less effective if dragged-along shareholders preserved their dissenters' rights under Michigan law.<sup>15</sup>

Dissenters' rights provide shareholders with a mechanism to require a corporation to repurchase the dissenters' shares when the corporation takes an action that fundamentally alters the character of the shareholders' investment. The rationale behind dissenters' rights statutes is linked to the elimination of the common-law requirement of unanimous shareholder approval for certain fundamental corporate actions.<sup>16</sup> In Michigan, share-

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holders voting against a corporate action have the right to dissent under Section 762 of the MBCA.<sup>17</sup> Holders of adversely affected shares who do not vote for or consent to a proposed corporate action, may dissent and receive payment for their shares.<sup>18</sup> The MBCA affords dissenters' rights in connection with corporate actions that make fundamental changes.<sup>19</sup>

Dissenters' rights may not be exercised if the shareholder votes in favor of or consents to the corporate transaction.<sup>20</sup> This raises the question of whether a shareholder who enters into an agreement with a drag-along provision agreeing to vote in favor of a transaction may, nonetheless, assert dissenters' rights.

While it appears that no Michigan court has considered the enforceability of an advance waiver of dissenters' rights in a reported decision, the language of the applicable provisions of the MBCA support the notion that a shareholder would not be entitled to pursue dissenters' rights following a transaction accomplished through the enforcement of drag-along rights, as such shareholder would be deemed to have voted in favor of the transaction. By requiring the shareholders to agree to take such actions necessary to effect a transaction (i.e., vote in favor of it) in a drag-along provision, the right to dissent is in effect being taken out of the hands of the shareholders. In theory, a drag-along provision should not create dissenters' rights because agreement to a drag-along provision will constitute "consent" to, or an agreement to vote for the proposed action, and a shareholder cannot assert dissenters' rights after consenting to or voting for a transaction.

Likely challenges to whether a drag-along provision constitutes a waiver of dissenters' rights would be on the grounds of public policy regarding waiver of statutory rights and general contract requirements for an effective waiver.<sup>21</sup> To counteract these potential challenges, drafters of drag-along provisions should consider the provisions of the MBCA covering voting agreements and shareholder agreements, and should include a provision that the shareholders are knowingly waiving statutory dissenters' rights.

#### *Voting Agreements and Section 488 Shareholder Agreements*

To increase the likelihood of enforcement of a drag-along rights provision and the likelihood that the drag-along rights provision would be viewed as an effective waiver of

statutory dissenters' rights one should consider the MBCA's provisions dealing with voting and shareholder agreements.

The MBCA expressly authorizes voting agreements among two or more shareholders.<sup>22</sup> Voting agreements may provide that the shares are to be voted in accordance with the agreement or as the parties may otherwise agree.<sup>23</sup> The only formal requirements of a voting agreement are that the agreement be in writing and signed by all the participating shareholders.<sup>24</sup> The MBCA does not limit the term of such agreements and the agreement need not appear in the corporation's articles or bylaws.<sup>25</sup>

The MBCA provides that voting agreements are specifically enforceable.<sup>26</sup> When drafting a drag-along provision, the drafter should consider including language that the shareholder agreement constitutes a voting agreement under Section 461 of the MBCA. As with MBCA provisions dealing with articles of incorporation and bylaws, voting agreements must generally be consistent with the provisions of the MBCA.<sup>27</sup> Thus, where the terms of a voting agreement are contrary to the MBCA, they may be held invalid.

The drafter should also be careful to specifically detail non-voting shareholder obligations under drag-along provisions because the controlling shareholder may need the non-voting shareholders to participate in the sale based on Section 615 of the MBCA and will need the non-voting shareholders to participate in the case of a stock sale. Section 615 of the MBCA provides non-voting shareholders the right to vote and exercise dissenters' rights in the event of a proposed amendment to the articles of incorporation if (i) "the amendment would increase or decrease the aggregate number of authorized shares of the class," or (ii) "alter or change the powers, preferences or special rights of the shares of the class...so as to affect the class adversely."<sup>28</sup> Because of the potential for non-voting shareholders to have the right to vote under Section 615 of the MBCA, it is necessary in transactions that may trigger a Section 615 voting right that practitioners ensure that non-voting shareholders sign a voting agreement or shareholder agreement with a drag-along provision even though they may not have a right to vote their shares generally. Furthermore, as discussed below, in order to have an effective Section 488 agreement, all shareholders must sign the agreement or the terms of the agreement must be set forth

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in the articles of incorporation or bylaws adopted by the shareholders.<sup>29</sup>

Even if a drag-along provision is ineffective as a voting agreement on the grounds it is inconsistent with the MBCA, the agreement containing the drag-along provision may be upheld under Section 488 of the MBCA. Section 488 expressly validates virtually all types of shareholder agreements and allows shareholders in closely held corporations to contract among themselves without restrictions.<sup>30</sup> Section 488 validates various types of agreements among shareholders determining their rights and obligations to each other and to the corporation, even when the agreements are inconsistent with the statutory provisions contained in the MBCA.<sup>31</sup> Thus, an agreement authorized by Section 488 is not “inconsistent with” the MBCA.

Section 488(1)(h) provides that an agreement among the shareholders of a corporation may otherwise govern “the exercise of the corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors, and the corporation, or among any of the shareholders or directors....”<sup>32</sup> Section 488(1)(h) is the so-called “catch-all” provision, which adds flexibility to the statute by allowing a shareholder to enter into shareholder agreements addressing matters not otherwise specifically enumerated.<sup>33</sup> The only express limitation on agreements under the “catch-all” is that they cannot be “contrary to public policy.”<sup>34</sup>

A drag-along provision governs the exercise of voting power by the shareholders and, while not expressly permitted by Section 488, is similar to the variations permitted by Section 488. As no Michigan court has addressed the issue in a reported decision, there still remains a question as to whether a shareholder’s statutory dissenters’ rights can be overridden by a Section 488 shareholder agreement or a Section 461 voting agreement.<sup>35</sup>

To the authors’ knowledge, no reported decision to date has specifically addressed whether a shareholder who enters into a voting agreement or shareholder agreement with a drag-along provision requiring a shareholder to vote his or her shares a particular way still has the statutory right to dissent. At least one court has enforced a drag-along provision. In *Minnesota Invco of RSA #7, Inc v Midwest Wireless Holdings LLC*,<sup>36</sup> the Delaware Court of Chancery was required to interpret complex agreements between

the members of a Delaware limited liability company and held that the defendant holding company had the right to “drag-along” holders of a minority interest in an operating subsidiary of the holding company in connection with the sale of the holding company.<sup>37</sup> *Minnesota Invco*, however, involved a limited liability company and not a corporation.

In another Delaware case, *In re Appraisal of Ford Holdings, Inc*,<sup>38</sup> the Court of Chancery held that, insofar as preferred stock is concerned, Delaware’s statutory dissenters’ rights may be modified by provisions of a certificate of designation for preferred stock.<sup>39</sup> In a dissenter’s rights challenge to a pre-determined payout on preferred stock on the occurrence of a sale transaction, the court stated that:

[P]roperly expressed terms of a Certificate of Designation of preferred stock may establish the consideration to which holders of the stock will be entitled in the event of a merger and, when the documents creating the security do so, that the amount so fixed or determined constitutes the “fair value” of the stock for the purposes of dissenters’ rights under Section 262 of the Delaware General Corporation Law.<sup>40</sup>

As a matter of policy in Delaware, there appears to be no *per se* rule against waiving statutory dissenters’ rights. The typical drag-along provision will not, however, provide for a predetermined price in the event of stock sale, but rather permit the dragged along shareholder to participate pro-rata in the proceeds of the sale and, therefore, the holding in *In re Appraisal of Ford Holdings, Inc* may be distinguishable on those grounds.

## Conclusion

Although ultimately it may be an issue for the courts to determine, a drag-along provision should be upheld under the MBCA as a voting or shareholders agreement and should likewise act as a valid waiver of any statutory dissenters’ rights because such provisions are the equivalent of a shareholder’s consent to a transaction. In light of the uncertainty concerning this issue, however, one should consider all types of transactions that are covered by the drag-along provision, since a transaction that is not contemplated by the drag-along provisions of the agreement will likely be viewed as an ineffective waiver of dissenters’ rights.<sup>41</sup> Although some have

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argued that a shareholder cannot waive the express statutory right to dissent on public policy grounds, one should remember that the MBCA expressly permits voting agreements and provides a high degree of latitude to shareholders entering into shareholder agreements under Section 488.

## NOTES

1. These types of agreements are commonly referred to as shareholder agreements, share restriction agreements, voting agreements, buy/sell agreements, and stock redemption agreements.

2. For a brief discussion of drag-along and tag-along rights, see Douglas G. Smith, *The Venture Capital Company: A Contractarian Rebuttal to the Political Theory of American Corporate Finance*, 65 Tenn. L. Rev. 79 (1997).

3. On the other hand, a tag-along right provision gives other shareholders the right to sell their stock as part of the sale by the Controlling Shareholder on similar terms and conditions.

4. Bruce A. Rubin, *Litigating "Drag-Along" Claims*, Association of Defense Counsel Membership Newsletter (January 2007).

5. Smith, *supra* note 2, at 132.

6. MCL 450.1753; MCL 450.1703a.; and MCL 450.1441

7. MCL 450.1753; MCL 450.1703a; and MCL 450.1762.

8. Subcommittee on Transaction Issues and Documents of the Committee on Venture Capital and Private Equity of the Business Section of the American Bar Association, *Comments to the Form Term Sheet Prepared by the National Venture Capital Association* 24 n.54 (August 2007) [hereinafter *Comments to NVCA Term Sheet*].

9. Comments to NVCA Term Sheet, *supra* note 8, at 25 n.60.

10. Comments to NVCA Term Sheet, *supra* note 8, at 25 n.60.

11. Rubin, *supra* note 4.

12. When representing a minority shareholder, who is also a director, that is considering resisting a drag-along rights provision, counsel should consider whether the director may have a fiduciary duty to benefit the corporation and not to resist the transaction. In addition, an agreement requiring a director to abdicate his fiduciary duties may be unenforceable as an impermissible restraint on the independence of the board of directors. See *Scripps v Sweeney*, 160 Mich 148 (1910).

13. Comments to NVCA Term Sheet, *supra* note 8, at 26 n.61.

14. See Smith, *supra* note 1, at 132; Joseph W. Bartlett, 1 Equity Finance, Venture Capital, Buyouts, Restructurings, and Reorganizations 1.1, at 1 (2d ed. 1995).

15. See MCL 450.1762. Such provisions may also violate the fiduciary duties of controlling shareholders. See *Ivanhoe Partners v Newmont Mining Corp*, 535 A2d 1334, 1344 (Del 1987) ("Under Delaware law a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation."); Christopher K. Aidun and Ernest Ceberio, *Current Trends in Venture Capital Financing: 2002*, Cyberspace Law. Apr. 2002, fn.3.

16. See *Voeller v Neilston Co*, 311 US 531, 535, n.6 (1941) ("At common law, unanimous shareholder con-

sent was a prerequisite to fundamental changes in the corporation. This made it possible for an arbitrary minority to establish a nuisance value for its shares by refusal to cooperate. To meet the situation, legislatures authorized the making of changes by majority vote. This, however, opened the door to victimization of the minority. To solve the dilemma, statutes permitting a dissenting minority to recover the appraised value of its shares, were widely adopted.").

17. MCL 450.1762.

18. MCL 450.1764.

19. MCL 450.1762. Under Section 762 of the MBCA, a shareholder is entitled to dissent from, and obtain payment for the fair value of his or her shares in the event of, any of the following corporate actions: (1) merger; (2) share exchange; (3) sale or exchange of all or substantially all the assets of a corporation; (4) amendment of the articles that adversely affect a class of shares; (5) a transaction giving rise to a right to dissent pursuant to section 754; (6) any corporate action taken pursuant to a shareholder vote to the extent the articles of incorporation, bylaws, or a resolution of the board provides that voting or nonvoting shareholders are entitled to dissent and obtain payment for their shares; or (7) approval of a control share acquisition. MCL 450.1762.

20. MCL 450.1764; MCL 450.1765. If a corporate action creating dissenters' rights under Section 762 is taken without a vote of the shareholders, a shareholder who consents to the corporate action is not entitled to assert dissenters' rights. MCL 450.1764(2). If a proposed corporate action creating dissenters' rights under Section 762 is submitted to a vote at a shareholders' meeting, a shareholder who votes his or her shares in favor of the proposed action is not entitled to assert dissenters' rights. MCL 450.1765(1).

21. E. Lee Reichert and John R. Chadd, *Dissenters' Rights: The Colorado Supreme Court Finally Speaks*, 34 The Colorado Lawyer 53 (April 2005).

22. MCL 450.1461.

23. MCL 450.1461; see also Stephen H. Schulman et al., *Michigan Corporation Law & Practice* § 4.15 (Aspen Publishers 2007).

24. Although the statute does not specifically require it, such agreements would also be subject to typical contract requirements, such as being supported by adequate consideration to be enforceable.

25. Schulman, *supra* note 23, at § 4.15.

26. MCL 450.1461.

27. Typically, the provisions of a corporation's articles of incorporation and bylaws may not contain provisions that are inconsistent with the MBCA or other state statutes. See MCL 450.1209 ("The articles of incorporation may contain any provision not inconsistent with this act or another statute of this state.").

28. MCL 450.1615.

29. See MCL 450.1488.

30. MCL 450.1488; Model Bus. Corp. Act Ann. § 7.32 cmt. at 7-75 (2005).

31. MCL 450.1488; see also Model Bus. Corp. Act Ann. § 7.32 cmt. (2005).

32. MCL 450.1488.

33. See Model Bus. Corp. Act Ann. § 7.32 cmt. (2005).

34. MCL 450.1488. Section 488 agreements must be set forth in the articles of incorporation, bylaws, or a written agreement signed by all shareholders, and the existence of the agreement must be noted conspicuously on the share certificates or on required information statements. MCL 450.1488.

35. See *Pratt Med Ctr v Meyer*, 57 Va Cir 462 (Va Cir Ct 1999). In *Pratt Med Ctr*, a trial court in Virginia held that the statutory dissenters' rights conferred upon the minority shareholder were not meant to be abrogated

by the automatic operation of a buy/sell agreement that is triggered because of the very actions the minority shareholder opposes.

36. 903 A2d 786 (Del Ch 2006).

37. *Id.*

38. 698 A2d 973 (Del Ch 1997).

39. *Id.* at 975.

40. *Id.* at 974.

41. *See Hansen v 75 Ranch Co*, 957 P2d 32 (Mont 1998). In *Hansen*, the Supreme Court of Montana interpreted section 35-9-301 of the Montana Business Corporation Act (the Montana equivalent to Section 488 of the MBCA) and concluded that the stockholders' buy/sell agreement did not contemplate the exchange transaction that occurred, or any other fundamental corporate changes in the corporation form (e.g., merger or share exchange) that would give rise to dissenters' rights. Therefore, the court determined that the stockholders' agreement did not control the resolution of the case but, rather, the provision of the Montana Business Corporation Act applied and, therefore, the minority shareholders were entitled to dissenters' rights.



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