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Restrictions on share issues and share transfers

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In this article, we look at some of the terms around issuing and transferring shares that are commonly negotiated as part of an equity term sheet.

Pre-emption rights

Pre-emption rights on an allotment of new shares give existing shareholders the right (but not the obligation) to subscribe for new shares on subsequent fundraising rounds in order to protect against dilution of their shareholding. Disapplication of these pre-emption rights will usually require a special resolution of the shareholders to be passed and, in some cases, investor consent. It is usual for the articles of association of the company to provide that pre-emption rights on an allotment will not apply in certain circumstances, such as if shares are issued to employees pursuant to a share option plan.

Pre-emption rights also typically apply on a transfer of shares by an existing shareholder. This gives other shareholders the right to acquire shares (pro-rata to their existing shareholdings) that another shareholder is proposing to transfer before they are offered to a third party.

Investors may sometimes seek to negotiate a 'super pre-emption' right, whereby they have a right of first refusal over any shares proposed to be issued or transferred by other shareholders before those shares are offered to any other shareholder.

It is usual for the articles of association of the company to provide that pre-emption rights on a transfer of shares will not apply in certain circumstances, such as where the transfer is to a permitted transferee (e.g. a spouse) of the relevant shareholder or where the drag-along rights (more on that below) are enforced.

Co-sale rights

Co-sale rights provide the ability for shareholders who have not taken up their pre-emptive rights on a proposed transfer of shares to sell a certain number of their shares on the same terms as the transferee (which may be limited to just the founders / employee shareholders or could be all other shareholders). This means that if the transferee has negotiated a sale of their shares at a certain price, the holder of the co-sale rights can elect to add their shares to the package that is being sold, on the same sale terms (with the initial seller's sale scaled back to accommodate any other sellers wishing to take part). These rights are designed to protect investors to ensure the valuation on share sales is controlled (i.e. not impacted by lots of minority shareholders all agreeing their own deals) and align themselves with management if founders are seeking to sell off a proportion of their shareholding.

Drag-Along Rights

Drag-along rights provide protection to majority shareholders of a company in the event of an exit. Investors will want to ensure that they have the ability to ensure a sale of the company backed by the holders of a majority of the shares goes through and achieve a return on their investment without minority shareholders being able to block the sale, given most prospective buyers will usually want to take control of 100% of the company.

Drag-along rights therefore enable the majority shareholders to force minority shareholders to sell their shares in the company to a third party, provided that minority shareholders are offered the same sale terms as the majority shareholders. The threshold at which drag-along rights operate will be an important point of negotiation in an equity term sheet and it is imperative that the final share capital table is taken into account when the mechanics around the operation of the drag-along rights are agreed.

Tag-along rights

Tag-along rights (also sometimes referred to as a mandatory offer on a change of control) typically go hand-in-hand with drag-along rights. Tag-along rights provide protection to minority shareholders by giving them the right (but not the obligation) to join in on a proposed sale of shares by majority shareholders to a third party. The trigger for the tag-along rights to apply is usually a change of control (so over 50%). This ensures that a minority shareholder is not forced to stay as a shareholder in a company following a sale of the majority of the shares in the company.