Drag Along Provisions in Israel

With IPO activity at a relative low, M&A transactions continue to be the leading means for growth in the Israeli high-tech sector. An important tool to guarantee that an M&A deal will be successfully closed is the “drag along” mechanism. The drag along mechanism allows a majority of shareholders to initiate a sale or change of control in the company and force the minority shareholders to participate in the transaction. This right is based on the premise that the minority shareholders should not be able to preclude the majority shareholders from selling the company and achieving liquidity, upon terms desired by the majority shareholders. Given the potential for the drag along mechanism to significantly ease the deal approval process, its provisions should be given careful consideration.

In Israel, a drag along is often effected by adoption of contractual drag along provisions by and among the shareholders of the company, either in a Founders Agreement, Shareholders Agreement, or in the Company's Articles of Association. Notwithstanding, Israeli law provides statutory drag along provisions under Section 341 of the Israeli Companies Law 1999-5759 (the “Companies Law”).

Section 341

Section 341 of the Companies Law contains a statutory drag along mechanism. Section 341 constitutes an alternative or even a default, against which a company may create parallel contractual rights in its Articles of Association.

Under the arrangement sanctioned by Section 341, an offeror who acquires at least 80%[1] of the shares, or a class of shares, of a company may force the non-selling minority shareholders to sell their shares on the same terms as the majority shareholders[2].

[1] However, companies formed prior to February 1, 2000 have a forced sale threshold of 90%, unless altered through an amendment to their Articles of Association.

[2] For the sake of calculating the 80%, the controlling shareholder of the offeror or anyone acting on behalf of the offeror, or the controlling shareholder of the offeror, are not taken into account.

According to Section 341, a shareholder opposing the sale may appeal to the courts in order to prevent the compulsory sale. The law also dictates a three-month timeframe for the drag along process as follows:

1. The purchase offer must be accepted within two months;
2. Following those two months the minority shareholder has one month to appeal to a court.

It remains unclear under Israeli case law whether such timeframes can be altered though the company's Articles of Association.

Drag Along Provisions

In practice, drag along provisions are commonly embedded in Articles of Association of Israeli companies, the specific terms of which can vary widely from the statutory drag along mechanism in Section 341, and which are based upon the shareholders' respective interests and priorities, as well as the company's needs.
When drafting drag along provisions, it is imperative to give careful consideration to their specific terms, as these can heavily influence their effectiveness. Naturally, majority and minority shareholders have opposing interests. Whether or not a proposed transaction can in fact trigger the drag along mechanism will depend upon whether the form of the transaction is covered by the provision. Provisions will commonly include language referring to a merger or sale of all or substantially all of the company's shares or assets. Generally speaking, at minimum, 50% of company ownership should be required to be sold in order to trigger the drag along mechanism, however this percentage can be set be much higher and still be effective. Dynamics between the majority shareholders are also important, and drag along provisions will commonly include a threshold percentage for the majority shareholders who need to agree to sell their shares, to effectively give each major shareholder a veto over the proposed transaction.

Majority shareholders would naturally prefer the drag-along process to be brief, while minority shareholders would prefer a more extended process. As mentioned above, it is unclear whether Israeli companies may implement drag-along timeframes which diverge from the three-month timeframe set forth in Section 341. In practice, however, drag along provisions are often silent on the matter of timeframes, allowing for an uncontested process to proceed quickly, but ceding to the legal minimum if a minority shareholder decides to exercise legal measures.

Attention should also be paid to the form of consideration received in the deal (which could be limited to cash or liquid securities, but could also include other assets), and to its allocation. Generally consideration is distributed pro rata, or if the company has more than one class of shares, in accordance with the liquidation preference. However, there are variations to take into account, for example whether or not contingent payments such as future earn-outs are considered part of the consideration available for distribution, or if shares with a more senior liquidation preference will also receive preference in terms of the type of consideration they receive in the transaction.

The success of a drag along mechanism depends upon its ability to guarantee the compliance of minority shareholders. To guarantee the timely conduct of a potential drag along sale, shareholders may agree to appoint a seller representative funded by an escrow fund. In some cases, minority shareholders may even agree to sign an irrevocable proxy or power of attorney that will become effective upon a qualifying transaction, which enables the majority shareholders to enforce their drag along right even when the minority shareholder is unwilling to abide by the agreed-upon mechanism.

Conclusion

Drag-along rights facilitate the sale of the company in the face of opposition from minority shareholders. Section 341 of the Israel Companies Law provides that if the holders of 80% of shares wish to sell, then all shareholders can be forced to sell. A company's Articles of Association often provide that where a specific percentage of shareholders (often including the holders of a specific percentage of preferred shares) agree to a bona fide third party purchase offer, all shareholders must then sell. Drag along provisions are common and useful, and are included in the Articles of Association of many companies. Although that the relationship of such bespoke provisions with the provisions of Section 341 has yet to be seriously tested in Israeli case law, in practice they live successfully in parallel, to the benefit of companies and their shareholders.

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