You have my vote! Voting agreements for private equity

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Introduction

Since the 1980s, private equity ("PE") has been booming worldwide. In the Netherlands, PE has often made the news: favourably, for its unprecedented success stories, but also unfavourably, because of questionable practices that push the boundaries of Dutch corporate law. Although PE's reputation has suffered some dents in recent years, its popularity among large institutional investors continues to grow. The rates of return on PE are often so high that investments in PE are paying off more than stock market investments. As a result, institutional investors are injecting large amounts of capital into PE, increasing the amount of PE investments.

So what is PE anyway? PE is an umbrella term for investing venture capital in unlisted companies. What sets PE investors apart from other shareholders is that they almost always take a majority stake in a target company and openly declare that they want to sell that stake again within three to seven years (an "exit"). Because this exit should preferably be profitable, the PE investor wants to have a say in the company so that they can make the desired strategic investments and restructurings. This is often achieved by granting further powers to the PE party by agreement, on top of the legal powers that all shareholders have (and majority shareholders in particular). An example of this is the concept of a voting agreement that is the subject of this article.

What is a voting agreement?

A voting agreement is an agreement that regulates how one or more parties will exercise their voting rights. This may concern voting rights on shares, but also the voting right of a member of the board of directors or of a supervisory board member in the meetings of their respective boards. Voting agreements between shareholders are in principle

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always permitted. A shareholder may exercise their voting rights to serve their own interests. They may therefore also conclude agreements on how to exercise those voting rights. For voting rights among the board of directors and supervisory board it is the other way around: in principle, members of these boards may not conclude any voting agreements. There are two reasons for this. First of all, in the performance of their duties they must exclusively pursue the interests of the company and its business. Secondly, the duties of a member of the board of directors or supervisory board member are tied to the individual member's person. A voting agreement that allows another person to determine how a member of either board votes would detract from this. Only in exceptional cases will a voting agreement between board members be deemed permissible. The situation must be specific, concrete and assessable, and the voting agreement may not jeopardize the independent performance of the duties by the individual member of the board of directors or supervisory board. This still sometimes occurs in joint ventures, for example, where the members of the board of directors might agree in advance that in the event of a tied vote they will appoint an expert. However, this article is confined to voting agreements between shareholders.

What are the boundaries of a voting agreement?

In a voting agreement, three important quantities come into contact and sometimes into conflict: freedom of contract, the interests of the company and its business, and the shareholder's own interests.
The basic premise underlying Dutch contract law is freedom of contract: in principle, everyone is free to make whatever agreements they consider desirable. Exercising that freedom can sometimes clash with the interests of the company and its business, however. In the case of a voting agreement, those interests impose limits on the freedom of contract when it comes to exercising certain rights (corporate and otherwise).

A shareholder's freedom to exercise their voting rights as they see fit therefore also means that, in principle, they may always conclude a voting agreement. However, the Dutch Supreme Court ruled as far back as in 1944, in its Wennex judgment, that concluding a voting agreement may not have "socially unacceptable" consequences: for example selling votes or making arrangements that are incompatible with the company's articles of association. The question of whether a voting agreement is permitted for an indefinite period of time also depends on the specific circumstances. In addition, the principle of reasonableness and fairness enshrined in Article 8 of Book 2 of the Dutch Civil Code, which applies to everyone involved in the company, also imposes limits on voting agreements. If compliance with a particular voting agreement would have unacceptable consequences, it is not permitted to enter into that voting agreement.

Examples of permitted voting agreements

In practice, voting agreements take various forms. A first example is a voting agreement that creates an exception to the offering obligation in the event of a proposed or mandatory transfer of shares. It is certainly not unusual in family companies for shares to pass from generation to generation. Often the various branches of a family participate in the joint family company through their own holding companies. To prevent a shift of shares in or behind the family branch's holdings from leading to an obligation to offer to sell their shares in the family company, it is commonplace to agree that the general meeting may decide to approve such a move. This often includes an arrangement that "approval will not reasonably be withheld in the event that the shares are transferred to a descendant first in line". Because PE often involves investing in companies of family-owned origin, it frequently creates encounters with such provisions.

Another specific type of voting agreement that often occurs in PE is that a minority shareholder has the right to appoint a member of the board of directors. As a rule, the general meeting appoints the board's various members by simple majority, and so a minority shareholder normally can do little to object. With a voting agreement, however, the minority shareholder can be granted a right of appointment that they would not normally have, contractually assuring them of the power to appoint one of the board members, regardless of the size of their shareholding.

Another example that is often encountered in practice is a voting agreement that is used for what is commonly known as "blocking". Where a majority shareholder is in opposition to two or more minority shareholders, those minority shareholders will often make an arrangement to vote as if they were a single shareholder. Block formation agreements can also be useful if there is no one majority shareholder, but several minority shareholders wish to form a single block in order to achieve the majority together. With PE, this can be useful if two or more PE parties separately acquire minority stakes in the same target company: together, they have a majority of the votes in the general meeting, and a block formation agreement is then an obvious route to take.

The purpose and use of voting agreements for PE

As mentioned above, one of the factors distinguishing PE investors from "normal" shareholders is that they take an active, or even very active, role in the company. For example, some PE investors participate in the board of directors or the supervisory board in order to exert influence. In this shareholder capacity, PE is bound by the powers and majority thresholds with respect to particular decisions as defined by law and the company's articles of association. These include the AGM's powers under the articles of association to appoint members of the board of directors and to adopt the financial statements, and the AGM's powers as set out in Article 107a of Book 2 of the Dutch Civil Code. That clause, which only applies to public companies, stipulates that the AGM's approval is required for management decisions that lead to a major change in the identity or nature of the company or the business, such as a decision to transfer the business or almost the entire business to a third party.

PE investors generally take a majority stake in the target company, and therefore usually do not experience any problems with effectuating decision-making in the general meeting. The basic principle is that resolutions require a simple majority (half of the votes cast plus one), unless the

law provides otherwise. These are usually cases where an enhanced majority is required, for example depriving the nomination to appoint a director of its binding nature. A voting agreement in which the required majority of the parties agrees to remove the binding nature may offer a solution in that case.

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In addition, voting agreements can also be used to prevent deadlocks within the general meeting. One example is a voting agreement in which the parties agree to appoint an expert if the meeting is in deadlock. This prevents the company’s business from suffering as a result of the deadlock, which might lead to a loss of value.

In summary, voting agreements make it possible to separate differences in rights and powers from share ownership. This eliminates any need to issue different classes of shares, and so makes it easier to sell the company in the event of an exit.

Deviation from the voting agreement and enforceability

In view of the foregoing, voting agreements can help to achieve results that might be impossible to realize on the basis of the shareholding alone. The disadvantage of a voting agreement, however, is that a shareholder may decide not to abide by the arrangements.

Because a voting agreement is a contractual obligation, it is possible, in principle, to deviate from it and to vote in contravention of the voting agreement. While this constitutes a breach of contract under the voting agreement, it does not affect the validity of the vote cast. Although non-performance leads to an obligation to compensate the loss or damage suffered, in practice it is often difficult to prove that a vote cast in deviation from the agreement has in fact caused any loss or damage, and the other parties to the agreement are generally left with no recourse. To avoid this problem of proof, most voting agreements (and many shareholder agreements) contain a penalty clause, on the basis of which a fixed amount (the penalty) will be forfeited in the event of breach of contract. If a penalty is incurred, it can only be mitigated in court, and then only to a limited extent. As a rule, any voting agreement will need to be performed. According to case law of the Dutch

Supreme Court, where acting in compliance with a voting agreement means that the shareholder votes in a way that they would not have voted without that agreement, this does not in and of itself mean that the voting agreement is impermissible. To that extent, therefore, the principle of freedom of contract takes precedence with voting agreements.

Although breaching a voting agreement does not, in principle, affect the validity of the vote cast, that does not mean that breaching the voting agreement cannot affect the validity of the resolution passed. In addition, a judgment of the District Court of The Hague also shows that a voting agreement to which all shareholders (and the company) are parties, for example in the form of a shareholders' agreement or an arrangement agreed in the company's articles of association, may lead to a voidable resolution if it emerges that one of the shareholders voted contrary to the agreement. The Amsterdam Court of Appeal has qualified this principle to some extent, however, ruling that enforcing the arrangements contained in the shareholders' agreement is not permissible if this would lead to unacceptable harm to the company's interests.

However, this will occur in exceptional cases only, so that in principle a resolution is voidable if a shareholder acted contrary to the agreement. This problem is less likely to arise, however, if a voting agreement is used for block formation: in that case, the intended objective may be achieved by means of an irrevocable power of attorney.

An irrevocable power of attorney means that one of the parties grants power of attorney to the other party to exercise the voting rights on its equity interest by proxy. As the name implies, it is impossible to revoke this proxy, and so this provides certainty that the vote will be cast in the manner agreed. An irrevocable proxy can only be granted for cases where the legal act matches the interests of the proxy or a third party. As a rule, this will always be the case, as the proxy holder will exercise the voting right in accordance with the agreement and therefore in accordance with their own interests. The disadvantage of a power of attorney, however, even an irrevocable one, is that the proxy holder remains authorized to exercise their own rights at all times, so that the risk remains of acts contrary to the voting agreement.

A final option is to enforce the voting agreement in court, by means of "real execution": the non-breaching party to the voting agreement petitions the court for authorization to cast the vote directly, or even for a court order that replaces

the vote. However, this will generally not be the preferred route. Not only is this a solution that can only be applied in extreme cases, but its use will also strain relationships within the company. It is therefore strongly recommended to make clearly defined arrangements about the purpose, performance and enforceability of the voting agreement.

Further information

Voting agreements come in many shapes and sizes, but are generally contained in a shareholders' agreement. A voting agreement can provide a solution in various cases involving an impasse or potential future points of contention. In addition, for private equity investors and other shareholders (whether they have a large or a minority shareholding), it can also offer a useful solution to help realize certain corporate goals, such as effectuating an exit or appointing preferred members to the board of directors. Voting agreements are always custom-drafted, and are highly dependent on the specific circumstances.

If you have any questions about using a voting agreement, or if you would like to know whether a voting agreement has binding force in your situation, please contact *Anique Noordam*.

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You can also visit our website to find out more about the Mergers & Acquisitions team at DVDW.