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Delaware Supreme Court Upholds Advance Waiver of Statutory Appraisal Rights

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The Delaware Supreme Court recently decided that an agreement (sometimes referred to as a “drag along”) to waive prospectively statutory appraisal rights is fully enforceable against the common stockholders who made such agreement in the circumstances described below. In doing so, the court in *Manti Holdings, LLC v. Authentix Acquisition Co., Inc. (Manti)* rejected the petitioners’ claim that an advance waiver of appraisal rights by common stockholders is per se against public policy and unenforceable as a matter of the Delaware General Corporation Law (DGCL).¹

To the contrary, the court held that the DGCL “does not prohibit sophisticated and informed stockholders, who were represented by counsel and had bargaining power, from voluntarily

agreeing to waive their appraisal rights in exchange for valuable consideration.” Therefore, the advance waiver of appraisal rights by these common stockholders made at the time they entered into a stockholders agreement subsequently barred them years later from exercising appraisal rights with respect to the sale of their company via a merger.

While it may seem surprising given the prevalence of drag-along rights, this decision marked the first time that the Delaware judiciary has directly addressed the enforceability of an advance waiver of appraisal against common stockholders.² Based on its facts, the *Manti* decision provides welcomed confirmation from the highest Delaware court of practices that the venture capital world has relied on for years. Below is some background information and a summary of this important decision for private companies and the venture capital investors who fund them.

¹ *Manti Holdings, LLC v. Authentix Acquisition Co., Inc.*, 2021 WL 4165159 (Del. Sept. 13, 2021).

² The Delaware Court of Chancery has previously upheld the enforceability of an advance waiver of appraisal rights against preferred stockholders, noting the “essentially contractual nature of preferred stock,” see *In re Appraisal of Ford Holdings, Inc. Preferred Stock*, 698 A.2d 973 (Del. Ch. 1997). The only Delaware case addressing the enforceability of an advance waiver of appraisal rights against common stockholders was decided on procedural grounds. It was determined that the particular drag-along rights were not properly invoked in the first instance, so the substantive question of whether the waiver of appraisal rights would be enforceable as a matter of the DGCL was not directly addressed, see *Halpin v. Riverstone Nat’l. Inc.*, C.A. No. 9796-VCG (Del. Ch. Feb. 26, 2015) (Glasscock, V.C.).

Statutory Appraisal Rights of the DGCL

Appraisal rights (sometimes called “dissenters’ rights” in other jurisdictions) are a feature of the corporation law of the state in which a company is incorporated. In general, these statutory appraisal rights entitle a stockholder who has not voted in favor of a specified sale of the company to forgo the price being paid by the acquirer and instead seek a post-closing judicial determination of the fair value of his or her shares, if certain procedural conditions are met. Such a judicially determined value can be greater, equal or lesser than the acquirer’s price, and the appraisal rights petitioner is required to accept the outcome (*i.e.*, no optionality to take the acquirer’s price if the judicially determined value turns out to be lower).

Section 262 of the DGCL provides appraisal rights with respect to the sale of a Delaware corporation that is structured as a merger where the approval of the target corporation’s stockholders is required under the DGCL and the merger consideration is cash (or stock, unless the “market-out exception” applies). The purpose of these appraisal rights is to protect minority stockholders who do not vote in favor of a merger from being squeezed out by the controlling stockholders for an unfair value.

Often when a private company is sold to a third party, it is structured as a merger, thereby triggering appraisal rights. Mergers are common because, as a practical matter, they best enable the board of directors of the company and its controlling stockholders, who are usually represented on the board of directors, to control the negotiations with the third party and obtain the requisite stockholder approval of the transaction, subject to applicable fiduciary duties, without the complications of involving minority stockholders until after the deal is signed and closed.

An alternative would be using a stock purchase agreement, which would avoid triggering appraisal rights. However, such an approach would require 100% of the target stockholders to participate, which often is impracticable if there are a large number of stockholders. For these and other reasons beyond the scope of this article (such as tax), private company sale transactions often are mergers, triggering statutory appraisal right under Section 262 of DGCL as described above.

Drag-Along Rights and Facilitating Venture Investment in Private Companies

Even when contemplating its initial investment in a company, a venture capital investor will always be mindful of its strategy for exiting the investment in the future, hopefully at a profit. Conditioning any new investment in a company on the stockholders of such company signing an agreement containing a drag-along right helps to facilitate such an exit.

Drag-along rights obligate stockholders to agree upfront to a future sale of the company if approved by the board of directors and the controlling stockholder(s) at the time, and if other conditions are satisfied, thereby preventing the minority stockholders from obstructing such a sale, even when the minority stockholders would receive no merger consideration pursuant to the waterfall provision in the company’s certificate of incorporation. In essence, drag-along rights give the controlling holder(s) the power to decide when to exit an investment and on what terms. Without having this control, venture investors might be reluctant to make new investments, which would be detrimental to private companies seeking capital and their existing stockholders.

Specifically, in the event of a sale of the company, drag-along rights require stockholders (i) in the case of a stock purchase agreement, to sell their

shares to the third party in the same proportion, and on the same terms, as the controlling stockholders, (ii) in the case of a merger, to vote for the merger, thereby making them ineligible to pursue appraisal rights under Section 262 and (iii) to refrain from exercising any applicable appraisal rights. The latter is an express waiver of appraisal rights.

While it may seem superfluous given that clause (ii) would have the same effect, the express waiver in clause (iii) is needed because, as a practical matter, many private companies approve mergers by the written consent of their controlling stockholders only (assuming they represent the requisite approval under the DGCL and the certificate of incorporation). Therefore, minority holders often do not actually cast the favorable votes for the merger that would be necessary to disqualify them from exercising appraisal rights with respect to such a merger.

Instead, the minority holders often hear about the merger in a Section 228 notice sent after the merger is approved and closed. This express waiver of appraisal rights creates greater certainty for the acquirer that it will not be subject to post-closing liability from appraisal claims, no matter the mechanics of how the target company obtained approval for the merger.³

The *Manti* Case

The petitioners in *Manti* were minority common stockholders at the time their private company, Authentix, was sold in 2017 to an unaffiliated third party in an all-cash merger approved by Authentix's board of directors and its controlling stockholders, including private equity investor Carlyle Group (Carlyle). As common

stockholders, the petitioners were entitled to receive essentially no merger consideration from this deal, as explained below. This outcome motivated the petitioners to seek appraisal rights, but an understanding of earlier events and facts is critical.

About 10 years earlier, the petitioners had been the majority holders of Authentix. As a condition of Carlyle acquiring Authentix in 2007 and enabling the petitioners to roll over their equity as minority common stockholders, Carlyle required all stockholders to enter into a stockholders agreement containing the following drag-along rights:

“[I]n the event that . . . a Company Sale is approved by the Board and . . . the Carlyle Majority, each Other Holder shall consent to and raise no objections against such transaction . . . , and . . . [shall] refrain from the exercise of appraisal rights with respect to such transaction.”⁴

In the negotiation of the Carlyle acquisition of Authentix, including this stockholders agreement, each of the petitioners, Authentix and Carlyle were represented by their own counsel, had bargaining power and received valuable consideration in exchange for entering in the transaction agreements. As the court put it, the stockholders agreement was “not a contract of adhesion.”

Fast-forward back to 2017: the exit transaction was approved only by the then controlling stockholders of Authentix, including Carlyle, via written consent. As minority holders at such time, the petitioners did not receive advance notice of the merger and were not given an opportunity to vote on the transaction. Shortly after the merger

³ For a fuller discussion of drag-along rights, including the advance waiver of appraisal rights, see Section 3 of the NVCA Model Voting Agreement (Updated July 2020) at this link: <https://nvca.org/model-legal-documents/>.
⁴ *Manti* (2021) at 11.

closed, the petitioners received notice of the closing and the cancellation of their shares of common stock and conversion thereof into a right to receive merger consideration.

Based on the liquidation preference provision in Authentix’s certificate of incorporation, which gave priority to preferred stockholders, there would be little to no merger consideration available to distribute to the petitioners and any other fellow common stockholders. Despite the drag-along rights above, the petitioners attempted to exercise appraisal rights.

Authentix, now under new ownership, moved to dismiss such actions, citing the above drag-along rights as constituting a valid advance waiver of statutory appraisal rights which Authentix was entitled to enforce against the petitioners as contractual obligations. The lower court agreed with Authentix. The petitioners subsequently appealed to the Delaware Supreme Court.

On appeal, the Delaware Supreme Court upheld the enforceability of the advance waiver of appraisal rights in the drag along, stating that the DGCL “does not prohibit sophisticated and informed stockholders, who were represented by counsel and had bargaining power, from voluntarily agreeing to waive their appraisal rights in exchange for valuable consideration.”

In rejecting the petitioners’ argument that appraisal rights are a mandatory feature of the DGCL and are so fundamental to the identity of a corporation that they cannot be contractually waived, especially in advance of a transaction, the court said “[a]t its core, the DGCL is a broad

enabling act that allows immense freedom for businesses to adopt the most appropriate terms for the organization, finance, and governance of their enterprise”, and noted that a public policy favoring private ordering is evident throughout the DGCL. The court further stated that:

“As a matter of public policy, there are certain fundamental features of a corporation that are essential to that entity’s identity and cannot be waived. Nonetheless, it is the Court’s view that the individual right of a stockholder to seek judicial appraisal is not among those fundamental features that cannot be waived.”⁵

The court also affirmed that an advance waiver of appraisal rights can appropriately be contained in a stockholders agreement and does not need to be included in the company’s certificate of incorporation pursuant to Section 151(a) of the DGCL, noting that it is a “personal obligation” and not an encumbrance of the property rights that runs with the stock.⁶

In reaching the foregoing conclusions, it is evident that the court was strongly influenced by the sophistication of the petitioners and the fact that Authentix was enforcing the waiver of appraisal rights against the very persons who used their bargaining power to negotiate for funding from Carlyle in exchange for waiving their appraisals rights — not any transferees or successors.⁷ Different facts might have resulted in a different outcome with respect to enforceability.

⁵ *Id.* at 3.

⁶ *Id.* at 25.

⁷ In this regard, the Court stated “...[t]he [waiver of appraisal rights] was not a ‘midstream amendment’ that was forced upon the Petitioners without their express consent.” *Id.* at 36, 37. It also stated the following with respect to the assignment and successors provision in the stockholders agreement: “And while the clause purporting to bind successors, assigns, and transferees may be unenforceable, the Stockholders Agreement has a severability clause, and Authentix is not attempting to enforce the [waiver of appraisal rights] against any stockholders that did not sign the Stockholders Agreement in exchange for consideration.” *Id.* at 26.

In a rare occurrence for the Delaware Supreme Court, there was a dissenting opinion. Justice Karen Valihura disagreed with the majority opinion for three main reasons. First, Justice Valihura viewed the terms of the waiver of appraisal rights as ambiguous in several regards, including whether the waiver survived the stockholders agreement, which terminated upon the closing of the sale of the Authentix.⁸ Second, she views appraisal rights as so fundamental to the identity of the corporate entity that, as a categorical matter, they cannot be waived. Third, if the legislature in Delaware were to permit such a waiver, Justice Valihura believes that such waiver would need to be included in the certificate of incorporation. Regardless of the views expressed in this dissenting opinion, the current state of the law in Delaware on this topic is as described above in the majority opinion.

Conclusion

For years, private companies and venture capital investors have used drag-along provisions containing an advance waiver of appraisal rights. This feature has been an important element in the private equity financing world, helping to facilitate investment in private companies. From a legal perspective, it has typically been assumed to be non-controversial, but untested judicially until now. The *Manti* decision provides welcomed confirmation of this practice, subject to the facts and circumstances of that case.

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