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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 et al. v. Authentix Acquisition Company, 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] 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.

Statutory Appraisal Rights of the DGCL

Appraisal rights 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.

Drag-Along Rights and Facilitating Venture Investment in Private Companies

> **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. The *Manti* decision provides welcomed confirmation of this practice, subject to the facts and circumstances of that case.**

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[1] Manti Holdings, LLC v. Authentix Acquisition Co., Inc., No. 354, 2020, 2021 WL 4165159 (Del. Sept. 13, 2021).

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Drag-along rights obligate stockholders to agree up-front 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. 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. While the latter may seem superfluous given that clause (ii) would have the same effect, it 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 merger.

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."*[2]

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. Shortly after the merger 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.

[2] Manti (2021) at 11.

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 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.[3]

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. Different facts might have resulted in a different outcome with respect to enforceability.

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. 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. The *Manti* decision provides welcomed confirmation of this practice, subject to the facts and circumstances of that case.

[3] Id. at 25.

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person would exercise in comparable circumstances. To fulfill their fiduciary duties, directors must consider what will maximize shareholder value in the long term. Businesses must account for ESG risks to achieve lasting commercial viability. Shareholders have been more vocal and involved in the governance of a business, demanding changes to leadership and the board of directors. We are starting to also see examples of shareholders successfully removing directors as a result of their discontent with the company's approach to climate change. This surge of ESG-related activity is driving companies to urgently transform their core strategies.