Advance Waivers of Dissenters' Rights

A recent Delaware case affirmed the legality of these waivers.

BY DOUG RAYMOND AND TODD SCHILTZ

One of the most important decisions a director can make is whether to sell control of a corporation on whose board they sit. Generally, shareholders also have a voice in this significant action, either by voting to approve a merger or the sale of substantial assets, or by agreeing to sell if the transaction is structured as a sale of stock. When shareholders vote on a sale of control, the deal will be approved if a majority of the shareholders (or, in some jurisdictions, a majority of those voting) vote in favor of the transaction. Thus, a majority of shareholders can force a merger or asset sale transaction on the minority even if the minority objects to material terms such as price.

To lessen this inequity, the laws of most states give minority shareholders who do not support a transaction and cannot block the deal the right to ask a court to determine and award them the fair value of their shares, even if it is significantly more than what is being paid in the deal. This right is referred to as "dissenters' rights" or the "right of appraisal."

While this may help protect the smaller shareholders, the right of appraisal can disrupt sale transactions, particularly if an acquirer anticipates that many shareholders will — or will threaten to — exercise these rights and introduce uncertainty around the ultimate sale price the acquirer will have to pay. While the board's fiduciary duties run to all — and not just controlling — shareholders, minority shareholders in many companies may not be well informed about the value and prospects of the business, and their exercise of dissenters' rights could introduce significant uncertainty into a transaction that the board (and the majority shareholders) have concluded is in the best interest of all shareholders. To reduce this uncertainty and the risk that small shareholders will seek a holdout price for their vote, boards often ask shareholders to agree to vote in favor of any transaction approved by the board and the majority of shareholders, and to not assert dissenters' rights.

In a privately held company, the board of directors may want to consider whether to seek a waiver of dissenters' rights before a potential acquirer enters the scene. Companies often ask minority shareholders to agree to go along with a transaction approved by the board and the majority shareholders, and to not assert dissenters' rights, at the time they make their initial investment in the company as part of the price for being permitted to invest. While this has been a typical provision in private company shareholder agreements, its legality, at least under Delaware law, has been subject to question. This legal ambiguity has given minority investors bargaining leverage even in transactions where their voting rights are insufficient to stop a transaction. In a recent case, *Manti Holdings LLC v. Authentix Acquisition Co., Inc.*, the Delaware Supreme Court settled the question and affirmed the legality of these provisions.

In *Manti*, Authentix's minority shareholders entered into a shareholders agreement in which, among other things, they agreed to "refrain from the exercise of appraisal rights" in connection with future transactions. Subsequently, Authentix was acquired in a merger where most of the sale proceeds went to the preferred shareholders, leaving little for the minority investors holding common stock. Minority investors sued, seeking a higher value for their shares, and argued that the advance waiver of their appraisal rights was invalid under Delaware law.

Ultimately, the case ended up before the Delaware Supreme Court, which addressed whether the Delaware General Corporation Law (DGCL) prohibits Delaware corporations from enforcing advance waivers of appraisal rights. The court agreed that, in many areas, the DGCL sets forth mandatory provisions intended to protect the interests of common shareholders, which cannot be modified or waived. However, after extensive analysis, the court ultimately concluded that the DGCL "does not prohibit sophisticated and informed stockholders, who are represented by counsel and have bargaining power, from voluntarily agreeing to waive their appraisal rights in exchange for valuable consideration." In reaching its decision, the court noted, "the DGCL is a broad enabling act that allows for immense freedom for businesses to adopt the most appropriate terms for the organization, finance and governance of their enterprise."

To reduce uncertainty and risk that small shareholders will seek a holdout price for their vote, boards often ask shareholders to agree to vote in favor of any transaction approved by the board and the majority of shareholders, and to not assert dissenters' rights.

The court's opinion also provided guidance as to when such waivers might not be enforceable, including when the corporation has sought to enforce an appraisal waiver against a small, unsophisticated stockholder with little bargaining power or an outsider who lacked material information. Thus, boards and majority shareholders who want to interpose these waivers should take pains to develop a record that minority investors who enter into such agreements were well represented and had access to all relevant information.

The Delaware court left unresolved whether the logic of its ruling would allow a board to enforce waivers of other DGCL provisions, such as those relating to a shareholder's right to access the corporation's books and records, to require an annual meeting of shareholders or even to nominate a director. The court's ruling, however, provides comfort that advance waivers of appraisal rights are valid and enforceable tools that, when properly employed, can be used to prevent minority shareholders from potentially upsetting a transaction approved by the board. ■

Doug Raymond *is a partner in the law firm of Faegre Drinker Biddle & Reath LLP (www.faegredrinker.com). He can be reached at Douglas.Raymond@faegredrinker.com.* ***Todd Schiltz*** *is also a partner at the firm.*