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## What a Drag (-Along)! Dealing with minority owners in M&A deals

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**W**hy a Drag? Many prospective sales of companies have foundered due to opposition by a minority of their owners. Minority shareholders may be able to disrupt a sale structured as a stock sale by refusing to tender their shares. In sales structured as mergers and in some circumstances asset sales, minority shareholders not voting in favor of the transaction can assert "appraisal rights" and invoke special appraisal proceedings which could result in a higher value paid to those owners than that provided for in the proposed transaction. The minority shareholders may also claim breach by the Board of Directors or the controlling owners of their fiduciary duties in effecting the transaction.

To address the risk of not being able to trigger a company sale at the time and on the terms of their choosing, controlling shareholders frequently insist that, well in advance of any transaction, all owners enter into a shareholders agreement which contains a so-called "drag-along" provision. A drag-along provision, which is sometimes referred to as the more benign-sounding "take-along" provision, typically allows controlling shareholders to require that all other shareholders vote in favor of and participate in a sale transaction approved by the controlling shareholders or by the Board of Directors. In fact, private equity and venture capital firms typically predicate their investment in a company on all shareholders having entered into an acceptable drag-along provision in a shareholders agreement.

### Challenges to Enforcing a Drag

A decision this past February by the Delaware Chancery Court provides a helpful illustration of the challenges in enforcing a drag-along provision and the importance of both proper drafting and execution of a provision. In *Halpin v. Riverstone National, Inc.*, the Court refused to compel minority common stockholders to execute a written consent and accept a merger payment and thereby waive the minority's appraisal rights. In *Halpin*, a 91% owner approved the merger, and the company closed the transaction. Only then did the company send minority shareholders a notice informing them of the transaction and invoking a drag-along right to compel the minority to consent to the transaction, thereby rendering them unable to assert appraisal rights. However, the drag-along provision relied upon provided only for the shareholders to vote in favor and participate in a *pending* transaction, not a *completed* transaction, and only after receiving *advance* notice, not *retrospective* notice, of the transaction.

In its decision, the Court noted that while Delaware courts have enforced contractual waivers of appraisal rights by *preferred* stockholders, Delaware courts have never ruled on whether waivers by *common* stockholders were enforceable, noting that common stockholders are entitled to greater fiduciary duty protections than preferred shareholders. The court also observed that the drag-along provision did not contain an express waiver of appraisal rights; instead, the parties had contracted for acts by the minority shareholders that would have the effect of waiving appraisal rights. It also noted that the remedy of specific performance to compel the minority to act is an extraordinary remedy imposing a high burden of proof on the controlling owner. Ultimately, the Court did not base its decision on the uncertainty in Delaware law concerning appraisal rights waivers by common shareholders; rather the Court determined that under the terms of the drag-along provision, the controlling shareholder was only entitled to rights exercised prospectively in advance of a pending merger, and the Court was unwilling to expand the provision to allow for retroactive exercise of rights.

### Takeaway Pointers

When negotiating drag-along provisions, controlling shareholders should seek broad, flexible rights which anticipate, as much as possible, the prospect of different M&A deal structures and procedures. Such rights should include clear

and conspicuous waivers of appraisal rights and provisions applicable to both prospective and completed transactions and to actions to be taken either at a shareholder meeting or by written consent. Particularly given that companies may have different classes of stock and that in many M&A deals, there are often legitimate reasons for not treating all company shareholders the same, care should be taken to limit inflexible application of rules requiring the same deal terms to all owners. Also, given the high burden imposed to receive specific performance as a remedy, controlling owners may want to insist on "self-help" type remedies, such as voting proxies and powers of attorney to enforce the drag-along provisions. They may want to also consider organizing the company as a limited liability company rather than a corporation as in general with LLCs, there is more flexibility in limiting the application of fiduciary duties and other minority owner rights.

As the *Halpin* decision demonstrates, controlling owners must carefully follow the drag-along provisions when executing the transaction. Moreover, given the uncertainty at least in Delaware as to whether an advance waiver of appraisal rights against common shareholders is enforceable and judicial concern over fiduciary duties owed to common shareholders, care should be taken to be able to demonstrate that in the merger the Board and controlling shareholders appropriately took into account the interests of the minority owners.

Finally, acquirers should not blindly assume that controlling owners of the target company can force minority shareholders into a deal just because a drag-along right exists. An acquirer too should evaluate the drag-along provision and its use in the transaction and consider protective measures to ensure that the consequences of invalid use of a drag-along are not imposed on the acquirer. Such measures may include requiring as a condition of the merger the receipt of appraisal right waivers or deal approvals by a very high percentage of owners and indemnity and other provisions which place the risk of appraisal awards on the controlling shareholders rather than the acquirer.

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