

DEAL LAWYERS

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VOL. 16, NO. 5

SEPTEMBER-OCTOBER 2022

How to Navigate the Decision of Exercising Drag-Along Rights During an M&A Process

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During an M&A process, the seller and its stockholders may consider whether it would be beneficial to exercise any drag-along rights under its stockholder agreements or equity plans. Drag-along rights generally allow a subset of the seller's stockholders (with the approval of the seller's board, depending on the requirements of the applicable agreement) to force other holders of the seller's securities that are subject to those terms (referred to in this Advisory as the Drag-Along Holders) to take (and refrain from taking) certain actions in connection with a sale transaction, subject to the requirements of the drag-along provisions.

Although one would think that triggering drag-along provisions in connection with a sale transaction would occur often given the protections it affords, these provisions are rarely utilized. That said, the exercise of drag-along rights is a tool that can be considered by the seller in discussion with its advisors (including as a result of a buyer requesting that they be triggered), especially in down markets when exit valuations and deal terms could increase the risk of appraisal claims and stockholder lawsuits.

Advantages of the Exercise of Drag-Along Rights

Customary drag-along rights provide a host of protections designed to mitigate the ability of Drag-Along Holders to create issues for a sale transaction if the requisite approvals are obtained and the terms are complied with. The Drag-Along Holders are typically subject to certain affirmative obligations (for example, voting in favor of the sale transaction and executing documents to support the sale transaction) and certain negative covenants (for example, prohibiting the exercise of appraisal rights and in some cases prohibiting certain breach of fiduciary duty claims). An officer of the seller may be granted a proxy to vote each Drag-Along Holder's shares in favor of the sales transaction and a power of attorney to execute supporting documentation if that Drag-Along Holder fails to promptly do so.

These terms, in their totality, give the seller and certain of its stockholders (often stockholders holding a majority of the seller's preferred stock) a tool to facilitate the transaction's closing (for example, to achieve required thresholds for stockholder approval, joinder agreements or the absence of appraisal claims) and to limit the likelihood of stockholder lawsuits and the stockholders succeeding in those lawsuits (which

could either derail the closing, deter a buyer from purchasing the seller, or lead to post-closing claims under the indemnification).

Disadvantages and Other Considerations for Exercising Drag-Along Rights

Prior to exercising any drag-along rights, the seller and its stockholders should consider the potential negative consequences of doing so. Outlined below are several topics which should be reviewed by and discussed with the seller and its advisors in deciding whether the exercise of drag-along rights, on balance with the advantages discussed above, will be beneficial to the sale transaction. The buyer may also consider whether it will require the seller to trigger the drag-along rights for many of the same reasons.

Fiduciary Duty Considerations. Drag-along provisions typically require a subset of the seller's stockholders to approve the exercise of the drag-along rights, but many also require the approval of the seller's board of directors. If the per share consideration in the transaction is not being allocated to shares of common stock and preferred stock equally, or there are other conflicts that could lead to a higher standard of judicial review in a stockholder suit (as detailed in cases such as *In re Trados Incorporated Shareholder Litigation*¹), the triggering of the drag-along rights could result in a claim for breach of fiduciary duty against the seller's board of directors. In one decision (*In re Good Tech. Corp. Stockholder Litigation*²), at least based on the facts before it in a breach of fiduciary duty claim, the Delaware Court of Chancery determined that it would ignore the exercise of the drag-along rights and the protections it affords.

Review the Drag-Along Provisions. Although there may be similarities among drag-along provisions, not all are created equal, and both the content and phrasing of the terms could have material implications on whether the drag-along rights can be exercised and how and when the exercise should occur. For example, if there is not an explicit restriction on exercising appraisal rights, the drag-along rights may need to be properly exercised in a particular manner prior to the closing of the sale transaction in order to prevent minority stockholders that are Drag-Along Holders from exercising appraisal rights (as provided for in *Halpin v. Riverstone National, Inc.*³).

Compare the Sale Transaction Terms Against the Requirements of the Drag-Along Provisions. Many drag-along provisions have specific requirements for exercise, which may be inconsistent with the terms of many sales transactions. There may also be ambiguity in the drafting of the drag-along provisions that may give Drag-Along Holders the ability to challenge the exercise of the drag-along rights or claim breach of the terms. The following are a few examples of terms to watch out for:

- The indemnification obligations proposed by buyer are often inconsistent with the requirements of the drag-along provisions (which may, among other matters, specify how the indemnification must be allocated among the seller's securityholders, cap the amount recoverable against a Drag-Along Holder absent that Drag-Along Holder's fraud, and specify which breaches a Drag-Along Holder could be responsible for).
- The scope of the representations and warranties buyers request in joinder and support agreements is typically broader

¹ *In re Trados Inc. Shareholder Litig.*, 73 A.3d 17 (Del. Ch. 2013).

² *In re Good Tech. Corp. Stockholder Litig.*, (Del. Ch. May 12, 2017).

³ *Halpin v. Riverstone Nat'l, Inc.*, C.A. No. 9796-VCG (Del. Ch. Feb. 26, 2015).

than those required to be made by the Drag-Along Holders under the drag-along provisions.

- The release of claims by the Drag-Along Holders proposed by buyer is often broader than the permitted scope of the release in the drag-along provisions.
- The allocation of consideration in a sale transaction may not be consistent with the language in the drag-along provisions requiring that stockholders receive the same consideration as one another in a sale transaction. For example, complexities can arise when there are accruing dividends, the seller has multiple classes of stock, or certain stockholders receive consideration in a transaction not shared by all stockholders.

Practical Suggestions and Conclusions

Each sale transaction will present different factors to be considered in deciding whether to exercise any drag-along rights that may be available. Outlined below are some practical suggestions that may be helpful in navigating this decision.

Consider what risks there may be for the sale transaction, what protections the drag-along rights provide, which seller's securityholders are subject to the drag-along provisions and whether the exercise of the drag-along rights help mitigate against the risks. For example, is the goal to constrain the exercise of appraisal rights, in which case the exercise of the drag-along in and of itself may be sufficient if the drag-along provisions restrict such activities explicitly, or are the goals broader and additional actions may be required?

Consider the thresholds of the seller's securityholders required to approve the transaction and sign supporting documentation. For those that are not required to so approve or sign those documents, are there larger holders or holders that present more of a risk of a lawsuit? Given the potential costs associated with an appraisal claim or a stockholder suit, is there a practical risk in light of the potential incremental gain that could be recovered, or could there be non-economic motivators that could drive a decision to bring such a claim or suit?

If the seller wants to maintain the optionality to exercise the drag-along rights, keep the drag-along provisions in mind during negotiations of the purchase agreement and related agreements for the sale transaction to ensure that the terms comply with the requirements of those provisions.

Consider the circumstances under which the drag-along provisions were entered into. Did each Drag-Along Holder execute the agreement that the seller would be enforcing against them? Are all Drag-Along Holders sophisticated parties that were aware of the restrictions at the time of entering into the agreement that includes the drag-along rights? If the answers to these questions are yes, then the facts should line up well with a recent Delaware case upholding a waiver of appraisal rights, *Manti Holdings, LLC et al. v. Authentix Acquisition Company, Inc.*⁴ If the answers are no, then it is important to understand that there may be issues involved that a Delaware court has not yet squarely addressed.

When negotiating the drag-along provisions themselves, attempt to be as clear as possible on what is required of the Drag-Along Holders, and

⁴Wilson Sonsini Alert, *Delaware Supreme Court Enforces Waiver of Statutory Appraisal Rights*, (September 16, 2021), <https://www.wsgr.com/en/insights/delaware-supreme-court-enforces-waiver-of-statutory-appraisal-rights.html>.

that the drag-along provisions cover all customary terms that could be relevant to Drag-Along Holders under the definitive agreements. It is also critical to include a proxy and power of attorney to limit reliance on having to specifically enforce the drag-along provisions if the Drag-Along Holder does not comply with such holder's obligations.

Being explicit on when the holder of the proxy and power of attorney can exercise those rights following a Drag-Along Holder's failure to comply could also limit challenges to their exercise. Finally, the parties may consider including forced sale provisions in its stockholder agreement, which certain companies have included in response to cases such as *In re Trados Incorporated Shareholder Litigation*, or at least to try to mitigate risks from such case law.

When drafting and approving the seller's equity plan, consider including drag-along provisions in that equity plan so that any holders of securities under the equity plan that are not otherwise a party to the stockholder agreements will be subject to drag-along rights.

When terminating the seller's stockholder agreements or equity plans, consider the interaction of termination provisions and the survival of drag-along provisions, although recent case law helpfully suggests that the terms of an exercised drag-along provision will survive the closing.

Be mindful of all corporate formalities that may be required under the seller's certificate of incorporation and bylaws. In addition, if the seller's organizational documents do not include a forum selection clause, the seller may consider amending these documents to include Delaware as the exclusive forum for stockholder lawsuits to avoid a minority stockholder attempting to bring its lawsuit in a forum that the stockholder thinks will be favorable to the stockholder's cause.

Generally, the seller's board of directors and advisors should also be careful to document in board minutes the board's process, its reasons for acting, its consideration of alternatives, and its understanding of its fiduciary duties and any conflicts of interest, and all parties should be mindful of other communications that could undermine the efforts of the board to create clear evidence of its intent. In some circumstances, where practicable, it may be helpful to have an independent board committee negotiate a transaction or obtain disinterested stockholder approval of the transaction. In such circumstances, the use of a drag-along provision may not advance the aims of such procedural protections.

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