

Kind of a Drag: Recent Delaware Decision Underscores Importance Of Following Procedural Rules Of Contracts

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February 01, 2015



Although the ultimate “home run” for venture capital investors remains an IPO of a portfolio company investment, for most investors the primary method of liquidity is an acquisition event. Mindful of this typical exit scenario, investors will often bargain for “drag-along rights” in their financing documents which contractually require all (or most) of a company’s stockholders to vote in favor of an acquisition event that is approved by a specified percentage of the company’s stockholders. A recent Delaware Court of Chancery decision serves as an important reminder that the failure to closely follow the procedural rules of exercising drag along rights can result in grave and unintended consequences for companies and their investors.

In *Halpin v. Riverstone National, Inc.*,¹ five minority stockholders of Riverstone National, Inc. (“Riverstone”) sought appraisal of their shares of stock in connection with the June 2014 merger of Riverstone and Greystar Real Estate Partners. The merger transaction had been approved by the 91% majority stockholder of Riverstone, CAS Capital Limited (“CAS”), who sought to obtain the minority stockholders’ approval of the merger by invoking the drag-along rights contained in a 2009 Stockholders Agreement. The Stockholders Agreement stated in relevant part:

*“[I]f at any time any stockholder of the Company, or group of stockholders, owning a majority or more of the voting stock of the Company (hereinafter, collectively the “Transferring Stockholders”) proposes to enter into any [Change-in-Control Transaction], the Company may require the Minority Stockholders to participate in such Change-in-Control Transaction with respect to all or such number of the Minority Stockholders’ Shares as the Company may specify in its discretion, **by giving the Minority Stockholders written notice thereof at least ten days in advance of the date that tender is required**, as the case may be. Upon receipt of such notice, the Minority Stockholders shall tender the specified number of Shares, at the same price and upon the same terms and conditions applicable to the Transferring Stockholders in the transaction or, in the discretion of the acquirer or successor to the Company, upon payment of the purchase price to the Minority Stockholders in immediately available funds. In addition, if at any time the Company and/or any Transferring Stockholders propose to enter into any such Change-in-Control Transaction, the Company may require the Minority Stockholders to vote in favor of such transaction, where approval of the shareholders is required by law or otherwise sought by giving the Minority Stockholders notice thereof within the time prescribed by law and the Company’s Certificate of Incorporation and By-Laws for giving notice of a meeting of shareholders called for the purpose of approving such transaction.”*

Rather than providing the minority stockholders with prior notice of the merger transaction (as required by the Stockholders Agreement), CAS informed the minority stockholders of the closing of the effectiveness of the merger a week after the closing of the transaction. In its notice to the minority stockholders, CAS informed the minority stockholders that it had exercised its drag-along rights and instructed the minority stockholders to execute a written consent approving the merger. The notice went on to state that if a minority stockholder executed the written consent, he would not be entitled to execute appraisal rights, but that if he did not exercise the written consent, he would be in breach of the Stockholders Agreement.

In its counterclaim to the minority stockholders' petition for appraisal, Riverstone sought specific performance of the drag-along provisions of the Stockholders Agreement. The court denied this request, finding that the express language of the Stockholders Agreement required advance notice of a proposed merger transaction and as such the drag-along rights were unambiguously prospective in nature. Riverstone was limited to the benefit of its bargain and, by a literal reading of the Stockholders Agreement, this did not include the power to require the minority stockholders to consent to a transaction that had already taken place. Riverstone also contended that the minority stockholders were compelled to consent to the merger due to the implied covenant of good faith and fair dealing, arguing that by entering into the Stockholders Agreement the minority stockholders implicitly agreed that they would participate in any merger approved by CAS. The court similarly dismissed this argument, finding that the minority stockholders' refusal to consent to the merger transaction was not arbitrary or unreasonable and that applying the "gap-filling" function of the implied covenant was not warranted.

Drag-along rights serve to facilitate the approval process related to the sale of a company by preventing stockholder dissent and undue leverage by minority stockholders. The Court of Chancery's decision in *Halpin* serves as an important reminder that drag along rights must not only be carefully drafted but properly exercised in order to serve their intended purpose.

For further information on this topic, please contact [Scott R. Bleier](#).

Footnote.

1 *Halpin v. Riverstone National, Inc.*, C.A. No. 9796-VCG (Del. Ch. Feb. 26, 2015)