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Appraisal Rights — The Next Frontier in Deal Litigation?

Although it is too early to predict whether we will see a true wave of appraisal cases, current market conditions and developments suggest that dissenters' rights may merit a reappraisal.

Appraisal, or dissenters', rights, long an M&A afterthought, have recently attracted more attention from dealmakers as a result of a number of largely unrelated factors. By way of brief review, appraisal rights are a statutory remedy available to objecting stockholders in certain extraordinary transactions. While the details vary by state (often meaningfully), in Delaware the most common application is in a cash-out merger (including a back-end merger following a tender offer), where dissenting stockholders can petition the Chancery Court for an independent determination of the "fair value" of their stake as an alternative to accepting the offered deal price. The statute mandates that both the petitioning stockholder and the company comply with strict procedural requirements, and the process is usually expensive (often costing millions) and lengthy (often taking years). At the end of the proceedings, the court will determine the fair value of the subject shares (i.e., only those for which appraisal has been sought), with the awarded amount potentially being lower or higher than the deal price received by the balance of the stockholders.

While deal counsel have always addressed the theoretical applicability of appraisal rights where relevant, a number of developments in recent years have contributed to these rights becoming a potential new frontier in deal risk and litigation:

- *Cash is King* — With cash representing the deal currency (either alone or together with stock) in approximately 90% of domestic M&A transactions over the last few years, the deals in which appraisal rights apply have multiplied as a percentage of overall volume. In addition, in the 2011 *Wesco* decision, the Delaware courts indicated that appraisal rights also would likely apply in cash/stock election mergers if the application of caps on the stock consideration meant that even shareholders who elect all-stock could be "required" to accept some cash as part of their merger consideration.

- *Hedge Fund Activity and Deal Controversy* — With a significant increase in capital available to hedge funds dedicated to activist, merger arbitrage and special situation activity and a seeming swell of deals attracting some form of stockholder opposition (e.g., distressed sales, PE or management buyouts, etc.), appraisal rights have attracted attention as an interesting new opportunity to deploy capital within the scope of these investors' expertise. Moreover, appraisal actions represent a more targeted "investment" opportunity given that the potentially increased consideration only flows to those shareholders who participate in the action (i.e., the benefits are not shared with the wider class of shareholders as is the case in generic deal litigation).

- *Appraisal Rights "Arbitrage"* — A little-noticed 2007 Delaware decision in *Transkaryotic* significantly increased the arbitrage opportunity available to appraisal rights "investors." Under the statute, holders may only seek appraisal if they do not vote in favor of the merger. It was thought by many that this requirement limited the remedy to stockholders who held their shares as of the record date (which long preceded the meeting and often even the preliminary proxy statement). Under this thinking, the opportunity to "buy into" an appraisal claim was often foreclosed to late-arriving investors. In *Transkaryotic*, the court endorsed a technical focus on Cede & Co. (the national clearing house for stock, also known as DTC) as the record holder for appraisal purposes. The court essentially held that any beneficial holder through DTC, regardless of when it acquired its shares, could seek appraisal rights as long as the total number of shares for which appraisal was sought was less than the total "street name" shares either voted against or not voted on the merger. As a result, appraisal investors can delay their decision on whether to acquire a stake for purposes of pursuing an appraisal action right up to the date of the stockholders meeting, giving

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them an opportunity for trend visibility as fair value is measured by the courts as of the date of closing (while the deal price may have been struck under different market or industry conditions months before).

- *Low Interest Rate Environment* — Under Delaware law, shareholders are generally entitled to statutory interest on the appraisal award at a rate equal to the Fed discount rate plus 5% from the closing date until the award is actually paid. Importantly, under a statutory presumption, absent good cause (such as the stockholder pursuing the appraisal in bad faith) this interest is paid (compounded on a quarterly basis) regardless of the ultimate appraisal decision (i.e., even if the court awards a per share amount less than the offered deal price). In today's ultra-low interest rate setting, the accumulating interest payments represent, if not an intriguing stand-alone investment opportunity, at least a meaningful offset to the extended period of illiquidity and litigation costs imposed on the dissenting shareholders for the duration of the proceedings. In fact, the mere threat of the mounting interest cost can coerce companies into considering unfavorable settlements with stockholders bent on pursuing an appraisal action.
- *Active Valuation Exercise* — In the seminal *Weinberger* case, the Delaware Supreme Court opined that appraisal valuation could be argued based on "any techniques or methods…generally considered acceptable in the financial community." While synergies resulting from the merger are not taken into account, other elements of future and speculative value can be advanced and no minority or illiquidity discount is assessed. In fact, in two recent decisions, *Orchard* and *Synthes*, the courts indicated that any "control premium" involved in the valuation exercise (e.g., in a comparable public companies analysis) had to be shared pro rata by all stockholders, even in the face of a controlling majority stockholder. Much like we have seen in the context of general deal litigation, recent years have shown an increased degree of sophistication and skepticism in the valuation exercise central to the appraisal action, both from the petitioners and the courts. An example of this more searching court analysis was seen in the *Golden Telecom* appraisal case where the Supreme Court decisively rejected deference to the negotiated deal price as a "market-checked" fair value, and instead supported the Chancery Court having formed an independent view on fair value with sophisticated textbook-style analyses of expert opinions and positions on such variables as expected tax rates and equity risk premiums and betas used in calculating discount rates. Given the courts' flexible approach to valuation, and the increasing sophistication of petitioners, the potential for more significant premium awards (and possibly discounts) has emerged. To put the issue in perspective (and recognizing that appraisal cases taken to completion likely reflect an element of self-selection bias), some studies have shown that the median premia achieved in appraisal actions is not much below 100%, and awards occasionally are as high as 400%.

While anecdotal evidence suggests that the volume of thought and discussion about appraisal rights has increased significantly, it remains to be seen whether a meaningful flow of litigated appraisal actions will follow. To the extent the pace increases, we expect that parties may again reassess the apportionment of risk around dissenters' rights. Closing conditions tied to the level of shares that assert appraisal rights are not common in the current deal market but may be reconsidered. Such conditions potentially impair deal certainty and create "hold up" value that can be exercised by a relatively small percentage of the outstanding shares. In addition, these conditions are of limited effectiveness in deals structured as tender offers. For deals heavily reliant on financing, dealmakers will need to at least consider the possibility of additional consideration being owed as a result of the appraisal process in creating a long-term and flexible "sources and uses" construct.

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