DEVELOPMENTS IN APPRAISAL LITIGATION

Delaware General Corporation Law gives stockholders objecting to a merger the right to have the Court of Chancery appraise and award them the "fair value" of their shares. Once seldom sought, appraisal proceedings have grown markedly in popularity in recent years. The authors discuss the Delaware statutory requirements for an appraisal, issues arising in the valuation process, and some recent rulings.

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Virtually every public company deal is subject to challenge by shareholders in the form of merger and acquisition (M&A) litigation. The statistics of M&A litigation are astounding and speak volumes to the frequency and prevalence of these cases. In 2013, for example, shareholders brought suit challenging 94% of all mergers and acquisitions valued over $100 million.[1] In recent years, however, a new type of shareholder deal litigation has also been brought with increasing frequency. Appraisal actions, or petitions filed by dissenting shareholders requesting that the court appraise and award the fair value of their shares, are provided for by statute in the Delaware corporate law. Although long considered to be of little use and an infrequent basis for a shareholder claim, appraisal cases are becoming much more common. This article outlines the statutory design of appraisal actions, discusses the typical issues and analysis in these cases, and examines the recent developments in this area.

DGCL SECTION 262 AND THE APPRAISAL PROCESS

Section 262 of the Delaware General Corporation Law permits stockholders who have perfected their appraisal rights to seek a determination of "fair value" from the Delaware Court of Chancery.[2] Behind this straightforward and simplistic summary of the statute, however, are a number of intricacies and procedural steps.

From the company's perspective, the company must give notice of the availability of appraisal rights to its shareholders at least 20 days before the meeting of the shareholders at which the vote on the merger is to take place. This notice must include a copy of the Delaware appraisal statute for the shareholders to review.[3]

At that point, a shareholder who desires to exercise his or her appraisal rights must deliver a written demand for appraisal to the company before the vote is taken. Merely voting against the merger, abstaining from voting on the proposal to adopt the merger, or failing to vote altogether are *not* sufficient measures for declaring the shareholder's appraisal demand. To exercise appraisal rights, the shareholder must not vote in favor of the adoption of the merger agreement. Stockholders seeking appraisal must not tender their shares for a cash offer.[4] Furthermore, the dissenting shareholder must continuously hold the shares of record from the date of the making of the demand through the effective time of the applicable merger to maintain his or her appraisal rights.[5] One issue that has been raised before the Court of Chancery is the point at which a shareholder must have acquired his or her shares to be eligible to exercise appraisal rights. Although it may seem counter-intuitive, and indeed several New York courts had held otherwise,[6] the Court of Chancery has explicitly held that a stockholder is not foreclosed from obtaining a statutory appraisal of his shares even if he or she purchased the shares after the terms of the merger were

[1] Shareholder Litigation Involving Mergers and Acquisitions: Review of 2013 M&A Litigation, Cornerstone Research.

[2] 8 Del. C. § 262.

[3] 8 Del. C. § 262(d)(1).

[4] *Id.*

[5] 8 Del. C. § 262(a).

[6] *See, e.g., Application of Stern*, 82 N.Y.S. 2d 78, 82 (N.Y. Sup. Ct. 1948) (holding that stockholders who had bought shares "in spite of" a merger were not entitled to appraisal).

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announced, so long as all other requirements necessary to perfect appraisal rights had been met.[7]

Within 10 days of the effective date of the merger, the surviving company must notify all shareholders who properly delivered a demand for appraisal that the merger has become effective.[8] Following the company's notification that the merger has become effective, an appraisal proceeding must be commenced within 120 days after the effective date of the merger by any dissenting shareholder who has complied with all other requirements of the statute.[9] This is done by filing a petition in the Court of Chancery demanding a determination of the fair value of the shares held by all stockholders who have properly demanded appraisal. At that point, the court holds a hearing to determine which shareholders have complied with the statutory requirements and are entitled to appraisal rights.[10] Following the eligibility determination, identical petitions are often consolidated and the court proceeds with the determination of the fair value of the shares in a process that is explained in greater detail below.[11] Once fair value is determined, a statutory rate of interest on that amount is awarded to the petitioner, calculated from the effective date of the merger.

A few remaining statutory provisions warrant discussion. First, a stockholder who has demanded appraisal but has not commenced an appraisal proceeding may withdraw his or her demand and accept the merger consideration, so long as this is done within 60 days of the effective date of the merger.[12] Outside of this 60-day window, a shareholder may still attempt to withdraw his or her appraisal demand, but the surviving company and the court must consent. Second, in the event that no petitions for appraisal are filed within 120 days after the effective date of the merger, all of the dissenting stockholders' appraisal rights are extinguished and all stockholders are entitled only to the merger consideration.[13] Lastly, the Delaware appraisal statute provides that "[t]he costs of the proceeding may be determined by the court and taxed upon the parties as the court deems equitable in the circumstances. Upon application of a stockholder, the court may order all or a portion of the expenses incurred . . . to be charged pro rata against the value of all the shares entitled to an appraisal."[14]

THE INCREASING POPULARITY OF APPRAISAL ACTIONS

There can be no doubt that the popularity of appraisal actions has increased markedly in recent years. Even in the late 1990s and mid-2000s, the appraisal remedy was seen as one of limited use and regarded by academics as a weak, impractical remedy.[15] Indeed, even between 2004 and 2010, the number of appraisal petitions filed in Delaware roughly corresponded with the level of merger activity.[16] Appraisal petitions throughout this time period were filed in only about five percent of qualifying transactions.[17] In 2011, however, the rate of appraisal petitions doubled, and it has continued to increase since.[18] In 2013, more than 15% of transactions that qualified as appraisal-eligible resulted in at least one appraisal petition.[19] The value at stake in these proceedings has also increased. The value of dissenting shares in Delaware appraisal actions between 2004 and 2012 ranged relatively consistently between $100 and $300 million.[20] In 2013, however, the value of dissenting shares in Delaware appraisal actions skyrocketed to nearly $1.5 billion.[21]

One of the possible driving forces behind this increase is the statutory interest award. As noted above, under Delaware law, shareholders are entitled to statutory interest on the appraisal award, compounded quarterly and calculated from the time of closing until

[7] *Salomon Bros. Inc. v. Interstate Bakeries Corp.*, 576 A.2d 650, 654 (Del. Ch. 1989).

[8] 8 Del. C. § 262(d)(1).

[9] 8 Del. C. § 262(e).

[10] 8 Del. C. § 262(g).

[11] 8 Del. C. § 262(h).

[12] 8 Del. C. § 262(k).

[13] *Id.*

[14] 8 Del. C. § 262(j).

[15] *See, e.g.*, Jesse Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 1005 (2006) ("The shortcomings of the appraisal remedy are widely known . . . appraisal is a remedy that few shareholders will seek under any circumstance.").

[16] Minor Myers & Charles R. Korsmo, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASHINGTON UNIV. L. REV. (forthcoming 2015).

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.*

the award is paid.[22] The statutory interest rate is the federal discount rate plus 500 basis points, or five percentage points. In the current low interest rate environment, this represents an attractive rate of interest, especially in light of the fact that the interest is paid regardless of the appraisal action outcome. Thus, a petitioner could receive fair value that is identical to or even lower than the merger price, but still receive the interest.[23] To an individual or casual shareholder with limited resources, this is not much of an enticement. But to institutional investors and hedge funds with potentially millions of dollars' worth of shares, this return on investment is one of the reasons why the appraisal remedy is so appealing, especially given today's interest rates.

In addition, as discussed above, a shareholder need not hold any shares prior to the announcement of the merger to be eligible for appraisal rights.[24] This means that a large hedge fund could purchase millions of shares of a company following its announcement of a merger, perfect and exercise its appraisal rights, and then wait patiently while interest accrues for the roughly 18-24 months that it usually takes for an appraisal action to conclude. This strategy is not without its risks because the appraisal perfection process is technical and strict, and the court may award fair value that is less than the merger consideration. But it can also prove highly lucrative. As a result, it is likely that appraisal litigation will only become more popular among institutional investors and hedge funds.

THE COURT'S DETERMINATION OF FAIR VALUE

In an appraisal proceeding, the Court of Chancery determines "the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with interest, if any, to be paid upon the amount determined to be the fair value."[25] Unlike most statutory remedies and structures, however, the Delaware General Corporation Law provides little in terms of guidance for this analysis. The statute requires the court to take into account "all relevant factors."[26] This has been interpreted to include myriad factors, such as the merger price itself, elements of future value, the company's own projections, analyst reports and projections, earnings prospects, and the nature of the enterprise.[27] Notably, both petitioner and respondent in an appraisal action have the burden of proving their respective valuations by a preponderance of the evidence.[28]

Because of the highly technical and complex valuation method, expert reports and testimony are often of critical importance in appraisal litigation. As the Delaware Supreme Court has noted, "[i]t is often the case in statutory appraisal proceedings that a valuation dispute becomes a battle of experts. This is evidenced by the fact that the Court of Chancery is frequently presented with conflicting expert testimony."[29] That is not to say, however, that the Court of Chancery simply rubber-stamps one of the experts' opinions. The Court of Chancery may reject the experts' conclusions and instead order the experts to adjust the various inputs to arrive at its own determination of fair value.

Experts for both petitioner and respondent may utilize multiple valuation techniques to arrive at their opinion as to the fair value of the shares. The three most common are the discounted cash flow ("DCF") analysis, a comparable companies analysis, and a comparable transactions analysis.[30] A typical DCF analysis involves several complicated steps. First, the expert estimates the value of future cash flows for a discrete period, based, where possible, on contemporaneous management projections. If these are not available, the closest in time and next most reliable projections are used.[31] Second, the expert estimates the value of the entity attributable to cash flows expected after the end of the discrete period. This is called a terminal value, and is typically estimated by way of a perpetual growth model. Third, the value of the cash flows for both the discrete period and the terminal value must be discounted using a certain discount rate.[32]

This basic framework is affected by numerous inputs, the reliability or adjustment of which by slight amounts can often lead to large discrepancies in fair value estimates. Three of the more important factors are the

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[22] 8 Del. C. § 262(h).

[23] *Id.*

[24] *Salomon Bros.*, 576 A.2d at 654.

[25] 8 Del. C. § 262(h).

[26] *Id.*

[27] *Tri-Continental Corp. v. Battye*, 74 A.2d 71, 72 (Del. 1950).

[28] *Merion Capital, L.P. v. 3M Cogent, Inc.*, No. 6247-VCP, 2013 WL 3793896, *4 (Del. Ch. July 8, 2013).

[29] *Cede & Co. v. Technicolor, Inc.*, 884 A.2d 26, 35 (Del. 2005).

[30] *3M Cogent*, 2013 WL 3793896 at *5.

[31] *Andalaro v. PFPC Worldwide, Inc.*, Nos. Civ. A. 20336, Civ. A. 20289, 2005 WL 2045640, at *9 (Del. Ch. Aug. 19, 2005).

[32] *Id.*

accuracy of the projections, the discount rate, and the terminal growth rate.[33] As noted above, the credibility and weight which are to be given to the projections are crucial in a DCF analysis. "Delaware law clearly prefers valuations based on contemporaneously prepared management projections because management ordinarily has the best first-hand knowledge of a company's operations."[34] That is not to say, however, that all contemporaneous management projections are granted deference. Management projections may be discounted if the financial prospects have changed significantly since the projections.[35]

The company's discount rate is also of critical importance to the fair value determination. The discount rate is typically established by calculating a weighted average cost of capital for the company at issue, which, in turn, is comprised of numerous sub-components, including the appropriate risk-free rate, the equity risk premium, and beta value.[36] Not surprisingly, the values that the experts for petitioners and respondents use for these sub-components often vary widely, creating a considerable gap in what the parties suggest is the appropriate discount rate. As a result, the Court of Chancery frequently must make the decision as to the appropriate value.

The final element of the DCF analysis which plays a significant role in the ultimate fair value estimate and, therefore, the outcome, in many appraisal actions is the terminal growth rate. As noted above, outside of the discrete period during which cash flows are projected for each year, a terminal value is calculated to predict the company's cash flows moving forward. This is done using a terminal or perpetual growth rate, which normally falls somewhere between the rate of inflation and the rate of expected GDP growth.[37] As is the case with the discount rate, the court typically determines the appropriate perpetual growth rate through a combination of analyzing the experts' analyses and conducting its own analysis.

[33] *See, e.g.*, *Cede & Co. v. Technicolor, Inc.*, No. Civ. A. 7129, 2003 WL 23700218 (Del. Ch. Dec. 31, 2003).

[34] *Doft & Co. v. Travelocity.com Inc.*, No. Civ. A. 19734, 2004 WL 1152338, at *5 (Del. Ch. May 20, 2004, revised May 21, 2004).

[35] *Towerview LLC v. Cox Radio, Inc.*, C.A. No. 4809-VCP, 2013 WL 3316186, at *19 (Del. Ch. June 28, 2013).

[36] *Cede & Co.*, 2003 WL 23700218 at *40-42.

[37] *Cox Radio*, 2013 WL at 3316186, at *26.

MERGER PRICE AS A FACTOR

One critical issue of the fair value determination that has recently been analyzed by the Delaware courts is the extent to which the court may rely on the transaction price in assessing the fair value of the shares. Although this issue has been raised before in appraisal actions, such as *Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Group*[38] and *M.P.M. Enters., Inc. v. Gilbert*,[39] a handful of recent decisions have brought the use of merger price as a factor in the determination of fair value to the forefront of appraisal litigation.

In *Golden Telecom*,[40] the Court of Chancery conducted an appraisal of the fair value of the dissenting shares following the merger of telecommunications firms VimpelCom and Golden Telecom. As is common in appraisal cases, petitioners contended that the fair value of the shares was a lofty $139 per share, while respondent claimed the value of the stock was merely $88 per share.[41] One of Golden Telecom's principal arguments was that the merger price, $105 per share, should be given deference because it reflected a market-tested price. Then-Vice Chancellor Strine rejected this argument for several reasons.

First, the court noted that the Special Committee that negotiated the merger never engaged in an active market check before or after signing the merger agreement.[42] Second, one of Golden Telecom's largest shareholders, Altimo, who owned 26% of the company, publicly stated that it would not sell its stake in another transaction, and Telenor, an 18% shareholder, was noncommittal about whether it would sell its stake; this meant that any

[38] *Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Group*, 847 A.2d 340, 343 (Del. Ch. 2004) (holding that the merger price was the most reliable evidence of fair value "[b]ecause the sales process was an effective one that involved the provision of confidential information to numerous potential buyers and because there is no evidence that the UFG board or its investment banker sought to achieve anything other than the highest possible value . . .").

[39] *M.P.M. Enters., Inc. v. Gilbert*, 731 A.2d 790 (Del. 1999) (holding that lower court did not err in refusing to compare DCF analysis figures to the merger value because "[v]alues derived in the open market through arms-length negotiations offer better indicia of reliability than the interested party transactions that are often the subject of appraisals . . .").

[40] *Global GT LP v. Golden Telecom, Inc.*, 993 A.2d 497 (Del. Ch. 2010).

[41] *Id.* at 498.

[42] *Id.* at 508.

prospective buyer faced the possibility that it would not have been able to acquire any more than 56% of Golden Telecom's shares.[43] Third, the market evidence actually indicated that VimpelCom bought Golden Telecom at a bargain. One bank suggested that Golden Telecom was worth $129 per share, and in the days following the announcement of the merger, VimpelCom's stock price rose.[44] In light of these facts, the court refused to rely on the merger price, instead opting to modify the two experts' discounted cash flow analyses and come up with his own figure of $125.49 per share.[45]

Golden Telecom appealed the decision, which brought the case before the Delaware Supreme Court. Golden Telecom argued that the Court of Chancery erred by failing to defer to the merger price and that Delaware should adopt a standard requiring conclusive, or, in the alternative, presumptive deference to the merger price in an appraisal proceeding.[46] Chief Justice Steele authored the opinion and rejected this argument outright. He pointed numerous times to the clear statutory mandate in Section 262(h) to consider "all relevant factors." The court held that "[r]equiring the Court of Chancery to defer – conclusively or presumptively – to the merger price, even in the face of a pristine, unchallenged transactional process, would contravene the unambiguous language of the statute and the reasoned holdings of our precedent."[47] Noting the possible consequences of such a holding, the court pointed out that the appraisal process was designed to be flexible and that establishing a deference like that proposed by Golden Telecom would shift the responsibility to determine fair value from the court to private parties.[48] The court ultimately held that Vice Chancellor Strine did not err by failing to defer to the merger price and did not abuse his discretion. Thus, the judgment was affirmed.

The Delaware Supreme Court's holding in *Golden Telecom* undoubtedly guided the Court of Chancery in another appraisal action, *Merion Capital, L.P. v. 3M Cogent, Inc.*[49] In this case, petitioners sought the appraisal of their shares following the acquisition of a biometrics technology company at a price of $10.50 per share. Petitioners claimed the fair value of the shares was $16.26, while the respondent argued for fair value of $10.12 per share. One of the respondent's arguments was that the court should rely on the merger price as evidence of fair value, particularly in light of the fact that four companies had expressed interest in acquiring Cogent and there was a modest amount of negotiation as to the merger price. Vice Chancellor Parsons declined to consider the merger price as an indicator of fair value, for two reasons. First, the court clearly disapproved of respondent's argument that the merger price indicated fair value because it also retained an expert who opined that the fair value of the shares was 38 cents lower. Second, the court noted that the respondent did not attempt to remove from the merger price "speculative elements of value that may arise from the accomplishment or expectation of the merger."[50] "In other words, Respondent asks this Court to rely on a merger price that it has not relied on itself and that is not adjusted to produce the going concern value of Cogent. Those deficiencies render the merger price largely irrelevant to this case."[51] The court instead favored a discounted cash flow analysis, adjusting several variables as he saw fit, and concluding that fair value was $10.87 per share.

Just a few months after *3M Cogent*, however, the court addressed the issue again in *Huff v. CKx*.[52] Following trial of this appraisal action, Vice Chancellor Glasscock held that the fair value of the shares was identical to the merger price. The court discussed the reliability of the merger price numerous times throughout his opinion. He noted that "it would be odd, however, if the sale were an arms-length, disinterested transaction after an adequate market canvas and auction, yet the challenge was that the price received did not represent 'fair' value."[53] The court held that "[a] law-trained judge would have scant grounds to substitute his own appraisal for those of the … experts, and would have no reason to second-guess the market price absent demonstration of self-dealing or a flawed sales process."[54] The court also explained that the Delaware Supreme Court's holding in *Golden Telecom* did not bar

[43] *Id.*

[44] *Id.* at 509.

[45] *Id.* at 524.

[46] *Golden Telecom, Inc. v. Global GT LP*, 11 A.3d 214, 216 (Del. 2010).

[47] *Id.* at 218.

[48] *Id.*

[49] *Merion Capital, L.P. v. 3M Cogent, Inc.*, No. 6247-VCP, 2013 WL 3793896 (Del. Ch. July 8, 2013).

[50] *Id.* at *5.

[51] *Id.*

[52] *Huff Fund Inv. P'ship v. CKx, Inc.*, No. 6844-VCG, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013).

[53] *Id.* at *1.

[54] *Id.*

the Court of Chancery from considering the merger price. Rather, the court held that, in certain situations, this consideration is entirely consistent with the mandate to consider all relevant factors.

In this case, the court deferred to the merger price for two reasons. First, the merger price was the product of a "thorough, effective" process that was "free from any spectre of self-interest or disloyalty," and "multiple entities made unsolicited, credible bids."[55] Second, neither party presented a reasonable and reliable alternative valuation method, due to the "significant and atypical valuation challenges" presented by the target company.[56] Because the court found that there were no comparable companies or transactions and that a significant portion of management's projections were unreliable, the merger price represented "the most reliable indicator of value."[57] The court awarded fair value in the amount of $5.50, the exact value of the merger price.

The conclusion that one can draw from this line of cases is that the Court of Chancery will factor the merger price into its fair value analysis, sometimes considerably so, when the process that resulted in that price is fair and the transaction is negotiated by uninterested parties at arms-length. The court may also give additional weight to the merger price in situations where other valuation techniques – the discounted cash flow analysis, comparable companies analysis, and comparable transactions analysis – would be inaccurate or unreliable based on the dynamics of the company at issue. Finally, it is clear from both the appraisal statute and the case law that regardless of the extent to which a party seeks to rely on the merger price as an indicator of fair value, any synergies or other elements of value that arise solely from the accomplishment or expectation of the merger must be subtracted from this value to reach the value of the company as a going concern.

CONCLUSION

To a layperson, determining the fair value of the shares of a company may not sound particularly daunting. Appraisal proceedings, however, are very complex. As illustrated above, the statutory requirements and procedural hoops of Section 262 render bringing an appraisal action a lengthy and detailed process, and dozens of issues arise in the determination of fair value of the shares. This complexity, and the highly technical nature of valuation, means that appraisal cases often come down to a battle of the experts. In an otherwise fair process, however, the case law supports the notion that the merger price itself can be the most reliable indicator of value. In any event, appraisal proceedings have become noticeably more popular in recent years, and we expect that this trend will continue in the future. ■

[55] *Id.* at *13.

[56] *Id.* at *1.

[57] *Id.* at *13.