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Keeping Current:

Delaware Appraisal: Practical Considerations

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As has now been widely noted, the number of post-merger appraisal petitions in Delaware has increased significantly in recent years. Through 2010, the number of appraisal petitions filed in Delaware roughly paralleled overall merger activity, with appraisal rights being asserted in about 5 percent of the transactions for which they were available. In 2011, the rate of petitions doubled to 10 percent. In 2013, 28 petitions were filed in Delaware, representing 17 percent of appraisal-eligible transactions. The amounts at stake have increased as well, with the value of dissenting shares seeking appraisal in 2013 ($1.5 billion) being 10 times the value of dissenting shares in 2004, and more than five times the value of dissenting shares at their highest point in the last five years. In 2014, 20 appraisal claims have been filed in Delaware through August.

Most of this increased activity is due primarily to the rise of appraisal arbitrage as a weapon of shareholder activists seeking alternative methods of influence and value creation in the M&A sphere. "Appraisal arbitrage" refers to the acquisition of target shares by hedge funds and activist investors after announcement of a merger, with the purpose of seeking appraisal rights (often accompanied by a call to other stockholders not to vote for the merger and to join in seeking appraisal rights for their shares). As shareholder activists acquire large equity stakes in companies in anticipation, or after announcement, of a bid for a company, appraisal rights offer a route to increased profit if a board negotiates a lower than expected price. Moreover, appraisal offers an alternative route to profit – without the challenge of having to prove any wrongdoing in connection with the transaction – if a breach of fiduciary duties action against a board is not successful.

The basic arbitrage opportunity presented by appraisal rights stems from the Court of Chancery's 2007 *Transkaryotic* decision, where the court, against expectations, held that investors that buy target company shares *after* the record date for the vote on a merger can still assert appraisal rights. This decision provided the foundation for activists and hedge funds to emerge as "appraisal investors," delaying until the date of the stockholders meeting a decision on whether to buy target company stock for the purpose of pursuing an appraisal action. With this timing advantage, investors can review information in the company's proxy statement relating to its sale process and fairness of the price, can assess any preclosing shareholder litigation that has been commenced, and can evaluate market, industry, and target company conditions at a time much closer to the merger closing date (as of which time the court will determine fair value in an appraisal proceeding), as compared to the time when the deal price was negotiated and then voted on.

A number of funds have been established that are devoted exclusively to appraisal actions as independent investment opportunities. Merion Capital, which has filed more than 10 Delaware appraisal actions, in late 2013 reportedly raised $1 billion for a fund dedicated to appraisal claims. Major mutual funds and insurance companies – institutions that have not been significantly involved in standard stockholder litigation – also have recently filed appraisal petitions. Appraisal arbitrage now commonly affects the public dynamics surrounding challenges to deals and can have a significant effect on the certainty and ultimate price paid in deals.

Even the threat of appraisal actions now commonly affects deal dynamics. Activists publicly and aggressively encourage other stockholders to join in an appraisal proceeding, increasing the threat of the proceeding to the target board – and thus, as a result, the activist's leverage in negotiating a settlement. Companies face significant risks that an appraisal proceeding may lead to a large appraisal award (even more problematic if financing arranged for the transaction will not be sufficient), or may lead to the transaction not being approved by the requisite stockholder vote (even more problematic if the required vote is a majority of all outstanding minority shares, since stockholders who want to seek appraisal cannot vote in favor of the merger). These risks prompt many companies to reach settlements (which often are large) with shareholders seeking appraisal rights. In the Dell going private transaction, for example, the threat by Carl Icahn and others to seek appraisal of the shares they had amassed after announcement of the deal effectively blocked the required shareholder vote (a majority of the minority shares outstanding) and led to a $400 million increase in the merger price paid to shareholders (as recently discussed publicly by legal counsel to the Dell special committee).

Why Appraisal Actions Were Rare In the Past

Appraisal litigation historically has been considered to be risky and costly. The wide discretion the court has under the statute to determine fair value makes the outcome of appraisal proceedings unpredictable. Fair value for these purposes is the going concern value of the company assuming the transaction giving rise to appraisal rights had not occurred (that is, excluding the value of merger synergies and a control premium). The appraisal proceeding usually involves a "battle of the experts" on both sides, with the burden ultimately on the court itself to make the determination of fair value, based on any methodology generally considered acceptable in the financial community. The methodology most often used by the court to determine going concern value is a discounted cash flow analysis, which is based in large part on assumptions and projections that themselves can be highly uncertain, including the company's internally generated projections and speculative data about how the company would have performed if the merger had not occurred.

Also, there are strict procedural requirements mandated by the statute and the process is typically quite lengthy and expensive. A key limiting factor to the attraction of appraisal actions has been the long period of time that a dissenting shareholder has its investment tied up while the proceeding is pending. The process usually lasts at least two years and involves a multi-day trial on the merits with extensive testimony from financial experts on both sides, as well as post-trial briefing and arguments. Importantly, unlike other litigation challenging a deal, stockholders are unable to proceed as a class and shift attorneys' fees to stockholders as a whole or to the defendants.

Why Appraisal Actions Have Increased

In addition to the phenomenon of appraisal arbitrage, discussed above, the well above market statutory interest payable on appraisal awards – 5 percent above the Fed discount rate, compounded quarterly and accruing from the closing date of the transaction to the date the appraisal award is actually paid – has encouraged the filing of appraisal petitions. Other factors include the increased stockholder challenges of all types to deals generally; an increase in the number of going private, management-led buyout and controller transactions, where conflicts of interest create skepticism about the deal price; and the willingness of the Delaware courts to consider a wide variety of arguments as to why fair value in a given case should be more than the merger price, often leading to appraisal awards higher than the merger price.

Results of the Delaware Appraisal Cases

An analysis of the post-trial appraisal decisions issued in Delaware since 2010 (summarized in the chart below) indicates that the court's appraisal determinations have exceeded the merger price in all but two cases – with the appraisal determinations representing premiums over the merger price ranging from 8.5 percent to 149 percent (with an average of 61 percent). The statutory interest paid on the appraisal awards represented an additional premium over the merger price of 11.7 percent to 214 percent (accrued over the period of the appraisal proceedings, which ranged from 2 years to 12.4 years, averaging 3.6 years). In the five cases that the court viewed as "interested" transactions (that is, mergers involving a controlling stockholder, parent-subsidiary, or management buyout), the appraisal amount was higher than the merger price in every case, with premiums over the merger price (not including the statutory interest) ranging from 19.5 percent to 149 percent. Notably, the sale process in each of these cases had not included a market check. The highest premium was awarded in a case in which an arbitration panel had already determined that the only reason for the merger was to eliminate the petitioner as the sole remaining minority stockholder – "without notice and without legal justification"; and that the court found involved "strong-arm tactics" by the controlling stockholder and a process that was "anything but fair."

By contrast, in the four transactions viewed by the court as "disinterested" (i.e., third party arm's length transactions), the fair value determination was higher than the merger price in two of them, but with premiums above the merger price (8.5 percent and 15.6 percent, respectively) that were below those in the interested transactions. In one of the disinterested transactions, the appraisal amount was equal to the merger price; and in one the appraisal amount was below the merger price (representing a 14.4 percent discount to the merger price).

Practical Considerations

The Overall Risk of Appraisal Arbitrage Has Been Overstated

Notwithstanding the notable increase in appraisal activity, it is 17 percent of appraisal-eligible transactions that attract appraisal petitions – while almost *all* strategic transactions now attract fiduciary duty litigation. Moreover, while the only consideration in an appraisal determination is the determination of going concern value just prior to the merger (and wrongdoing by the target board or flaws in the sale process have be held by the court to be legally irrelevant for these purposes), the transactions that attract appraisal petitions, and that result in appraisal awards with the highest premiums over the merger price, are transactions that involve some basis for a belief that the deal price significantly undervalued the company (i.e., interested transactions).

Need to Consider the Likelihood of Appraisal Petitions and the Possible Effect on the Transaction

In general, acquirors must evaluate the possibility of an appraisal proceeding being a component of the process in mergers and acquisitions transactions. If an arm's length transaction has been subject to an aggressive competitive process, the pursuit of appraisal then would seem more unlikely. At the other extreme, a transaction with a company controller or a private equity deal with major management participation would be a probable suspect for the assertion of appraisal rights, particularly if the sale process appears to raise questions. Other transactions between these extremes will require a careful evaluation of the facts and circumstances to determine the likelihood of appraisal rights being sought and, if so, the possible effect on the transaction.

The obvious advice is that buyers need to build into their financial models the possibility of an appraisal award after the transaction closes. The advice is problematic, however, given both the effect on the bid's competitiveness and the potentially significant amount of the appraisal award (plus the above market interest). The anticipated internal rate of return for a transaction can be significantly adversely affected by an unanticipated post-closing cost (whether due to a court determination or settlement of an appraisal claim or of fiduciary litigation), and it is very difficult to model for such an outcome. Of note, appraisal settlements have become increasingly difficult to reach as investors focus on the benefits of the above market interest rate that accrues until payment of the appraisal award.

Increased Risk and Uncertainty for Transactions

The increased strategic use and threat of appraisal actions can increase uncertainty and risk both for buyers and sellers. Closing uncertainty for both sides increases with inclusion of an appraisal rights condition (discussed below). Without an appraisal rights condition, buyers are faced with the uncertainty that a significant payment may become payable to dissenting shareholders post-closing; that arranged financing may not cover the full required payment to shareholders (because the amount payable to dissenting shareholders will be uncertain even after closing); and that a shareholder vote requiring a percentage of all outstanding disinterested shares may not be obtainable (because dissenting shares cannot vote). Moreover, investors can threaten appraisal without later following through – providing a no-cost route to exerting the pressure that results from actually bringing an appraisal action.

Importantly, the company's sale process, as well as the range of fairness established by the target company's bankers, is unknown to the buy-side party until the company's proxy statement is furnished to shareholders. A buyer – for example, a private equity firm in a management-led buyout (where the court can be expected to be skeptical of the transaction) – may want to try to avoid attracting appraisal petitions by offering a price at the high end of the fairness range and by acquiescing in (or even encouraging) a robust sale process by the seller. Critically, however, even in this case, the buyer has no certainty as to whether the seller may have improperly prepared the company projections, conducted the market check or dealt with any conflicts, or otherwise may have acted in ways that could render the process unreliable – and thus invite appraisal demands. Buyers, particularly those in transactions that will be most at risk for attracting appraisal petitions, may begin to seek ways to obtain some protection in this area, such as, possibly, including representations as to the process in the merger agreement or requiring information about the process before signing the merger agreement.

In addition, there is uncertainty about how the court will determine fair value in any given case. As discussed above, it is reasonably predictable that an arm's length transaction that included a meaningful market check will not result in an appraisal determination significantly above the merger price, and that an interested transaction without a meaningful market check may well result in an appraisal determination significantly above the merger price. It is not necessarily predictable, however, what the result will be in any given case that falls between these extremes – i.e., where in an arm's length transaction there has been a less than perfect market check or in an interested transaction there has been a meaningful market check. Certainly, a court, when it evaluates the extent to which a deal price is a relevant factor in determining fair value, will be more likely to give deference to the deal price if it was reached after an arm's length negotiation in a pristine sale process that included an effective market check.

Consideration of an Appraisal Condition to a Merger

Acquirors may again consider use of appraisal rights conditions, which used to be common – i.e., a condition to the merger that not more than a specified percentage, often 10 percent, of the outstanding target shares seek appraisal rights. Of course, sellers will resist this condition as it effectively reallocates the risk associated with appraisal rights to the seller. Buyers in a competitive process will be wary to include this condition as it would be likely to significantly diminish the competitiveness of the bid as compared to bids not imposing the condition. An appraisal rights condition may be most attractive to (or even necessary for) a financial buyer or a buyer with significant financing needs for the transaction.

Importantly, it is difficult to predict the effect of an appraisal rights condition on a transaction. On the one hand, the condition helps to provide more certainty to the acquiror by limiting the potential exposure to appraisal rights. On the other hand, the condition may provide more leverage to last-minute opportunistic investors who can threaten to derail the deal by triggering the condition, thus causing more uncertainty for both the buyer and the seller. At the same time, though, it may be that activists and hedge funds will ensure that the condition is *not* triggered, as their least preferred alternative will be a deal that does not close (in which case they would receive neither the merger price nor appraisal rights).

Conclusion

Despite the significant increase in the filing of appraisal petitions in recent years, and the not insignificant uncertainty associated with appraisal cases, appraisal petitions still are not filed in a large majority of transactions (with about 17 percent of appraisal-eligible transactions attracting petitions in 2013, as compared to almost all strategic transactions now attracting fiduciary duty litigation); appraisal cases are largely self-selecting for transactions in which the apparent facts provide a basis for believing that the merger price significantly undervalues the company; and, when an appraisal case is brought, it is unlikely that the appraisal determination will significantly exceed the merger price in a non-interested transaction that included a meaningful market check.

Accordingly, parties to transactions, when considering merger price and sale process issues, will want to factor into that calculus the risk associated with appraisal. Target company stockholders, when deciding whether or not to seek appraisal, will want to consider the nature of the transaction and the reasonableness of the price and process—including the nature and extent of the market check in the sale process, the presence of any other features lending credibility to the merger price (such as a majority-of-the-minority stockholder vote requirement for the merger), the range of fairness determined by the target company's investment bankers in connection with their fairness opinion, the investment bankers' underlying financial analyses supporting their range of fairness, and the general reaction of the market and analysts.

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Additional Materials

For a discussion of "appraisal arbitrage," please see "The Rise of Appraisal Arbitrage," published in Insights Corporate & Securities Law Advisor (July 2014); "Perspective on Appraisal Arbitrage – and a Look at Delaware's Most Recent Appraisal Cases," Fried Frank M&A Quarterly (2nd Quarter 2014); and "New Activist Weapon – A Look at Appraisal Arbitrage Cases," published in Law360 (August 7, 2014).