Coming to Grips With Appraisal

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The Arrival of the New Asset Class

As readers are well aware, within the last few years the number of M&A cash-out transactions with respect to which stockholders have exercised statutory appraisal remedies under Delaware law has exploded.[2] The forces animating this development are many.

Driven by favorable case law regarding appraisal eligibility requirements,[3] a statutory interest rate on the carried appraisal investment that compares favorably to historically low interest rates, the availability of dedicated funding sources and several spectacular judgments and settlements–a cottage industry of professional appraisal arbitragers and hedge funds and their copy cats has emerged to exploit this new asset class.[4]

Institutional investors, unhappy with proposed deal consideration, have been willing to join the fray and provide further scale to the dissenting group. At the same time, recent developments in Delaware case law with respect to traditional deal litigation have made that avenue less desirable for plaintiff stockholders.[5] With their deal hold-up leverage reduced, and facing the omnipresent threat of early case dismissal and discovery hurdles, it is no surprise that many stockholder plaintiffs have opted for the post-deal appraisal forum despite its expense and time commitment.[6]

In an effort to quell this tsunami of appraisal actions, the Delaware legislature made two changes to the appraisal statute in 2016. First, de minimis claims are now generally prohibited. Instead, appraisal shares must represent more than 1% of the target's outstanding shares and must be worth more than $1 million at the deal price.

Second, companies can now partially or completely eliminate the interest rate arbitrage opportunity afforded to dissenting stockholders by Delaware's relative high statutory interest rate by prepaying all or part of the potential appraisal award. The statutory rate, which is 5% over the Federal Reserve discount rate, runs from the date of the transaction to the date of payment of the award. Appraisal actions can take years to litigate or settle. The ability to prepay now allows companies to cut off this accrual.

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[1] The views expressed herein are the authors' and do not necessarily represent the views of the authors' law firm or its other lawyers.

[2] According to a recent study, 62 appraisal actions were filed in 2016 (representing shares otherwise entitled to $1.9 billion in aggregate merger consideration), compared to 16 appraisal actions in 2012 (representing shares otherwise entitled to $129 million in aggregate merger consideration). *See* Guhan Subramanian, Using the Deal Price for Determining "Fair Value" in Appraisal Proceedings, February 6, 2017 Draft, Forthcoming in the Corporate Contract in Changing Times: Is the Law Keeping Up? (U. Chicago Press) (hereinafter "Using the Deal Price").

[3] A stockholder is eligible to seek appraisal if it, among other things, has not voted for the merger. The Delaware appraisal statute notes that "stockholder" in this context means a stockholder of record, such as Cede & Co., which is the stockholder of record for the vast majority of public company certificated shares. Delaware courts have ruled that a beneficial owner holding shares in "street name" through a broker is not required to prove that each appraisal share was not voted for the merger. Rather, it is adequate if Cede & Co. owns a sufficient number of shares that are not voted for the merger. *See In re Appraisal of Transkaryotic Therapies, Inc.*, 2007 WL 1378345 (Del. Ch. May 2, 2007). This means opportunistic appraisal arbitragers can jump into deals post-announcement.

[4] According to a recent study, Merion Capital, which has a dedicated appraisal arbitrage fund, filed numerous appraisal actions in Delaware between 2009 and 2016, representing shares otherwise entitled to $1.8 billion in aggregate merger consideration (or 36% of the total value of all claims for such period). *See* Using the Deal Price.

[5] In a recent line of cases, Delaware courts held that when a transaction that does not involve a controlling stockholder standing on both sides of the transaction is approved by a fully informed, uncoerced vote of disinterested stockholders, the business judgment rule will irrebuttably apply in a post-closing damages lawsuit even if some higher standard of review, such as *Revlon or Unocal*, would otherwise apply. *See Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015). Delaware courts also extended this rule to two-step tender offers under Section 251(h) of the DGCL where disinterested stockholders who are fully informed and uncoerced tender a majority of their shares. *See In re Volcano Corporation Stockholder Litigation*, 143 A.3d 727 (Del. Ch. 2016). In another well-known case, the Delaware Court of Chancery warned that disclosure settlements are likely to be met with disfavor unless the requested disclosures address a plainly material misrepresentation or omission and the release is narrowly tailored. *See In re Trulia, Inc. Stockholder Litigation*, 129 A.3d 884 (Del. Ch. 2016).

[6] Appraisal actions typically take about three years to resolve and involve significant costs, including lawyer and expert fees. *See* Gaurav Jetley and Xinyu Ji, Appraisal Arbitrage—Is There a Delaware Advantage?, The Business Lawyer; Vol. 71, Spring 2016.

In our view, neither of these amendments alone is likely to materially curtail the number of appraisal actions. The minimum claim requirement is easy for sophisticated players to satisfy and it is unlikely that the favorable statutory interest rate was the deciding factor for stockholders weighing whether to dissent in most instances. In addition, the prepayment option can actually free up capital for the dissenting stockholders, tempering the effect of the lost interest rate arbitrage. There is currently no legal mechanism to claw back prepaid amounts if they end up exceeding the court's appraisal award.

Deal Price and Appraisal Price: Venus and Mars

Of course, the increase in the incidence of appraisal might be only a minor nuisance for dealmakers were it not for the risk that the appraisal price might significantly exceed the deal price. That risk exists because deal price and appraisal price are products of fundamentally different processes influenced by different policy considerations.

Appraisal under Delaware law is a legislative remedy designed to provide the minority of target stockholders who disapprove of a deal with a judicial determination of the intrinsic worth of their holdings.[7] In contrast, the deal price is a negotiated price determined by the buyer and the target. In overseeing the negotiation of the deal price as agents on behalf of the target stockholders, target boards are focused on satisfying their fiduciary duties, including the duty of care. In this context, the Delaware case law has developed to protect target boards from the very thing the appraisal statute provides—a judicial determination of the correct fair price.

Quite intentionally, through the creation of the business judgment rule presumption, the Delaware courts have insulated target boards from judicial second-guessing as long as the board is not conflicted and has acted in an informed manner. Accordingly, case law has generally focused on the target board's *process* for determining a fair price and not the *determination* or *output* of that process.

Target boards have responded by seeking to ensure an informed decision-making process. Following the *Smith v. Van Gorkom*[8] case in 1985, a centerpiece in this process has become the target board's receipt of one or more fairness opinions from investment banks.[9] Of course, a fairness opinion is not an appraisal, but rather is the opinion of a financial advisor that a specified transaction is within a range of values encompassing financial fairness.[10]

As these two similar but distinct branches of target company valuation have matured over time, practices and patterns have developed around the inputs and methodology that can result in vastly disparate outputs. In appraisal actions, Delaware courts have typically focused on the discounted cash flow approach,[11] among a wide range of valuation metrics, and have more recently placed an emphasis on the deal price if there is meaningful and arm's length price competition for the target.[12]

In M&A transactions, target boards and their financial advisors also rely on a wide range of valuation metrics, most frequently relying on three valuation methods,[13] but often emphasizing the premium over the pre-announcement trading price and how the deal compares to similar M&A transactions. For example, in the controversial *Dell* case, in which the appraised value exceeded the deal price by 28%, the financial

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[7] *See In re Appraisal of Dell, Inc.*, 2016 WL 3186538, at *20 (Del. Ch. May 31, 2016).

[8] 488 A.2d 858 (Del. 1985).

[9] *See* DGCL 141(e).

[10] *See* Steven Davidoff, Fairness Opinions, 55 AM. U.L.REV. 1557 (2006).

[11] *See, e.g., Dell*, 2016 WL 3186538, at *45 ("The DCF analysis is a well-established method of determining the going concern value of a corporation.").

[12] *See, e.g., In re DFC Global Corp.*, 2016 WL 3753123 (Del. Ch. July 8, 2016); *Merion Capital LP v. BMC Software, Inc.*, 2015 WL 6164771 (Del. Ch. Oct. 21, 2015); *LongPath Capital, LLC v. Ramtron Int'l Corp.*, 2015 WL 4540443 (Del. Ch. June 30, 2015); *Merlin P'rs LP v. AutoInfo, Inc.*, 2015 WL 2069417 (Del. Ch. Apr. 30, 2015); *In re Appraisal of Ancestry.com, Inc.*, 2015 WL 399726 (Del. Ch. Jan. 30, 2015); *Huff Fund Inv. P'ship v. CKx, Inc.*, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013). Commentators and legal scholars have also proposed frameworks, including that if a deal process involves an adequate market canvass, meaningful price discovery and an arms-length negotiation, then a court should presume that the deal price constitutes "fair value." Others have argued that the deal price should prevail unless there are material disclosure violations or the target board is misinformed or biased. Still others argue that the Delaware Court of Chancery should have broad discretion in determining "fair value." *See* Using the Deal Price.

[13] *See* Study of Publicly Disclosed Fairness Opinions – Sneak Peek at Some Interesting Findings, Duff & Phelps, January 28, 2017.

advisors relied heavily on a leveraged buyout valuation model given that the interested potential buyers were private equity funds.

However, the *Dell* court noted that the LBO model did not yield a "fair value."[14] This was exacerbated by the fact that the pre-signing and post-signing market checks only yielded interest from other financial sponsors who relied on a similar valuation model. The court in *Dell* also noted that there was a widespread gap between the market's short-term valuation of the company, based on quarter-to-quarter results, and the operative reality of the company following an approximately $14 billion investment in its transformation.

A rough summary of key differences between the appraisal approach and the fairness opinion approach, focusing on a typical cash-out deal, includes the following:

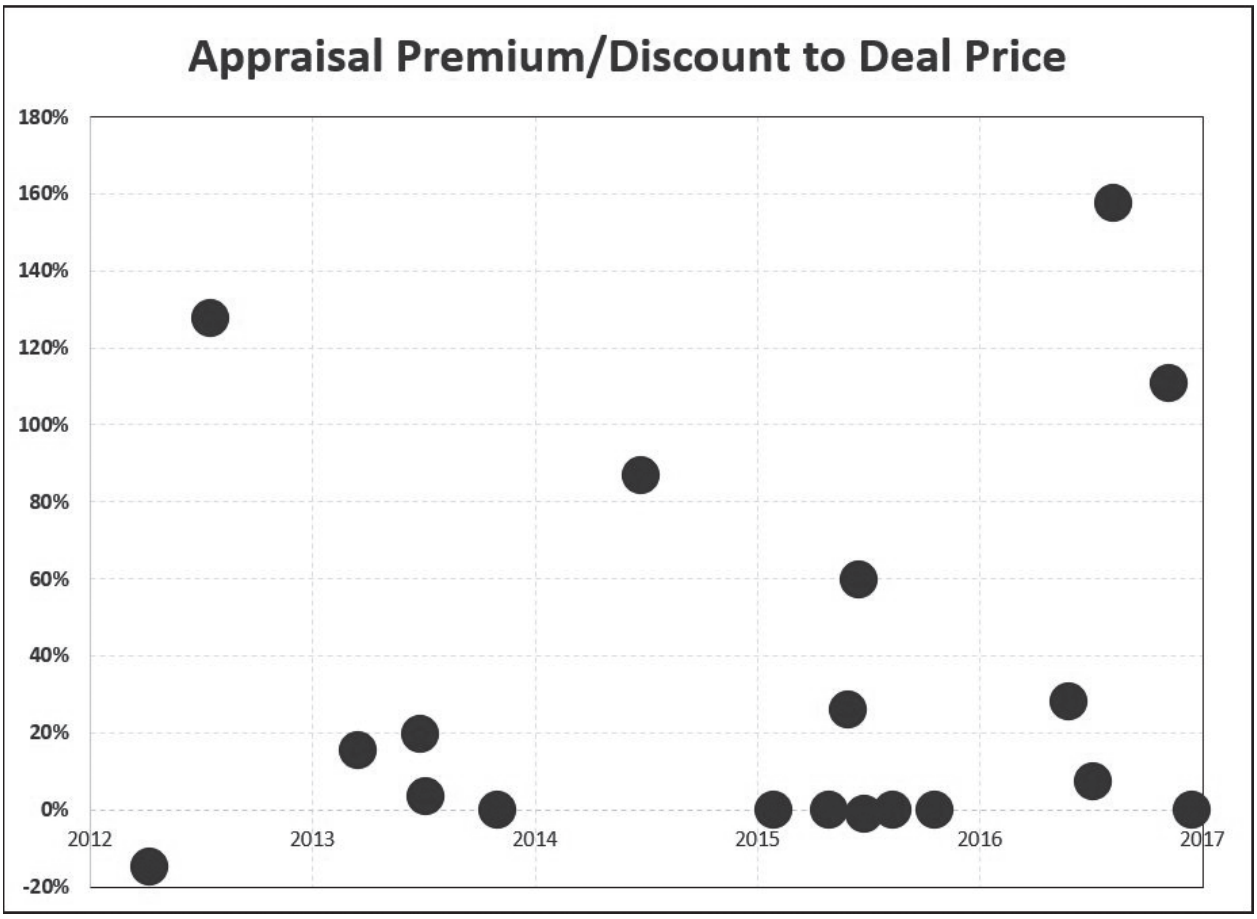
Appraisal Approach	Fairness Opinion Approach
• "Fair value"	• "Fairness from a financial point of view"
• Granular analysis, including growth rates, terminal value, discount rates and multiples, capital structure, cost of equity and debt, risk and size premiums, nature of comparable companies or deals, affordability models of buyer	• Broader and more generalized approach
• Single valuation number	• "Range of fairness"
• Date of completion of transaction[15]	• Near or at the date of execution of agreement
• Exclusion of "any element of value arising from the accomplishment or expectation of the merger"[16]	• Inclusion of all or a shared portion of synergies
• Among the wide range of valuation metrics, a focus often on the discounted cash flow valuation approach and, recently, deal price based on a robust market check	• Among a wide range of valuation metrics, a focus often on offers from a robust market check
• "Comparable company" valuation approach should gross up minority discount	• Often no gross up
• "Comparable transaction" and discounted cash flow valuation approaches should discount control or synergy premiums	• Often no discount
• Battle of competing experts under oath	• Non-adversarial professional opinion
• More focus on pre-deal, "unbiased" management projections	• More tolerance of adjustments due to changed circumstances or imperfect prior models

[14] *See Dell*, 2016 WL 3186538, at *29. Note, as of this date, the *Dell* case is currently on appeal to the Delaware Supreme Court.

[15] *See Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182 (Del. 1988).

[16] In *Merion Capital v. Lender Processing Services Inc.*, 2016 WL 7324170 (Del. Ch. Dec. 16, 2016), the court seemed receptive to the idea of deducting synergies in its calculation of "fair value" if timely raised and argued.

Given these different criteria, valuation conclusions can vary, sometimes dramatically. Set out below are the premium or discount, if any, to deal price that dissenting stockholders have realized through selected appraisal actions or settlements between 2012 and 2016. Perhaps one reason for the continued deluge of appraisal actions is that dissenters see little risk given how seldom courts have ruled that the deal price exceeds the appraisal value.



Source: Using the Deal Price and other publicly available data.
Note: Premiums exclude any interest payable in respect of the appraisal award.

Considerations for Buyers

Buyers, which are ultimately on the hook for any incremental appraisal liability over the deal price, have the greatest interest in taking steps to evaluate and possibly mitigate that liability. For obvious reasons, buyers typically do not have access to the target's fairness opinion before agreeing to the deal price. But buyers typically make use of fairness opinion-style valuation techniques (generated internally or by their own financial advisors) when negotiating the deal price. Buyers can use an understanding of the differences between the appraisal approach and the fairness opinion approach to prepare a valuation under each approach and factor into their deal price the risk of appraisal awards at the higher price.

In the current environment, buyers will need to better assess the importance of pushing for an appraisal condition, and its threshold. This condition, which gives the buyer a termination right if a specified threshold percentage (often 10% to 15%[17]) of the target's shares demand appraisal, has been limited in use in stock deals and is exceedingly rare in cash deals.[18]

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[17] *See* Using the Deal Price; American Bar Association, Strategic Buyer/Public Target M&A Deal Points Study (for transactions announced in 2015) (hereinafter "Deal Points Study").

[18] The American Bar Association sampled strategic deals valued at over $200 million in 2015 and found that no cash deals had appraisal conditions, compared with 6% of stock deals. *See* Deal Points Study. Another recent study found that only 3% of public company deals larger than $2.5 billion between 2009 and 2016 included appraisal conditions. *See* Using the Deal Price.

A buyer can argue that imposing the condition does not materially increase the uncertainty of the transaction occurring because the condition should chill the number of appraisal requests—after all, if the condition is triggered and the buyer walks, there is no appraisal opportunity. Nevertheless, sellers have often been successful pushing back against this condition, and the appraisal condition thresholds are typically so high that they lose relevancy as a liability management tool for buyers. It remains to be seen if the needle will move on the customary terms in this area.

Stock-for-stock deals, which are generally exempt from Delaware's appraisal statute,[19] could provide protection to buyers, but other deal considerations, including the sheer deal economics and the potential need for buyer shareholder approval, will likely supersede any appraisal-related benefits. In stock and cash mixed consideration deals, buyers can attempt to negotiate for protection by pointing to the potential threat of an appraisal award to the tax-free nature of the transaction, a typical condition in these deals.[20]

The rise of Section 251(h) "medium form" tender offers, which permit a buyer to simultaneously close a tender offer and a back-end merger (typically even if only a simple majority of the target's shares have been tendered), has helped buyers mitigate the risk of a substantial gap between signing and closing,[21] but there is still a significant risk that the deal price at signing may differ materially from "fair value" at closing, particularly if the deal involves a lengthy regulatory approval process.

Buyers could also seek to decrease the risk of a significantly higher appraisal price by cooperating with targets to bolster the perceived reliability of the deal price as a proxy for fair value.[22] However, it can be counterproductive for buyers to agree to terms that permit a more robust market check of the deal price.

Considerations for Targets

Experience suggests that target boards and their advisors do not typically analyze in much detail, if at all, the potential for different outcomes between the fairness opinion and appraisal approaches in their assessment of a potential sale transaction. After all, the duty of care fiduciary standard focuses on process, an appraisal condition may not be present in the acquisition agreement, and if appraisals are perfected and pursued after the consummation of the deal, it is the buyer's sole risk. Although it will be necessary for a dissenting stockholder not to vote for the transaction, dissenters as a group infrequently represent a large enough bloc to exercise control or negative control over the outcome of the vote.

It is possible that the plaintiff's bar, faced with *Corwin, Trulia* and their progeny, might try to construct a new type of fiduciary duty claim around the alleged failure to negotiate for a deal price as high as the likely appraisal price, or the failure to disclose the difference between the deal price and the likely appraisal price. The plaintiffs might also argue that a target board should not be in a position to recommend to its stockholders that they vote for a deal or tender their shares unless the target board has reasonably satisfied itself that the estimated appraised value is not higher than the deal value.

However, it seems unlikely the Delaware judiciary would allow such claims to gain any traction given the weight of jurisprudence against second-guessing a target board's determination of fair price, absent bad faith or gross negligence. The fact that a judicial determination of fair price after an adversarial

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[19] See DGCL 262(b).

[20] For a typical mixed stock and cash deal seeking tax-free treatment for the stock component, cash ("boot") can represent no more than 20% of the aggregate consideration in a reverse triangular merger under Section 368(a)(2)(E) of the tax code, and not more than 60% of the aggregate merger consideration in a forward triangular merger under Section 368(a)(2)(D) of the tax code. Payouts under appraisal actions, if available, count as boot in either kind of transaction. A mixed stock and cash deal is often structured as a reverse triangular merger into the target followed by a forward merger into the acquiring parent or another limited liability company directly owned by the public parent. These transactions are eligible to use the more generous boot limitation afforded to forward mergers and also avoid corporate level taxes on the targets' assets in case the transactions do not qualify for tax-free treatment. Forward mergers, including reverse mergers followed by internal forward mergers, can take advantage of the signing date value for measuring the cash versus stock limitation if the merger consideration meets the requirements for fixed consideration under the regulations, but reverse mergers relying on Section 368(a)(2)(E) of tax code must use the value on the closing date.

[21] *See Technicolor*, 542 A.2d 1182. Where regulatory or other conditions, or the need for extended financing marketing periods, results in longer closing dates, the parties will often use a merger rather than a tender offer structure to secure target shareholder approval and cut off "fiduciary outs."

[22] *See supra* note 12 and accompanying text.

proceeding might differ from a negotiated deal price is not surprising. Valuation is not an exact science and reasonable people can disagree.[23]

In some situations a target board will wish to make deeper appraisal value inquiries as part of their process. The use of the investment bankers on the deal to assist in this inquiry may be challenging, however, as it is not part of their customary engagement mandate or field of expertise. It is possible that in particularly delicate matters a target board might employ a second financial advisor to perform this service under a non-contingent fee structure.[24]

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It remains to be seen whether the recent surge in appraisal actions represents a new normal in M&A deals or a blip, with such actions eventually settling back to historical levels and Venus and Mars more or less coming back into alignment. Continuing developments in deal and appraisal case law, legislation, deal technology and the broader markets will all play a part in answering that question. For the time being, this appraisal development poses continuing challenges for both buyers and sellers, with no easy solutions.

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[23] *See, e.g., Dell*, 2016 WL 3186538, at *45.

[24] Even if the investment banker were willing to provide some form of advice as to what a hypothetical appraisal value would be, a further question is whether the built-in conflict with respect to investment banker deal fees renders such advice too suspect to rely on. The case law regarding conflicts with respect to deal fees has generally been favorable to the traditional investment banker fee structure. *See, e.g., In re Smurfit–Stone Container Corp. Shareholder Litigation*, 2011 WL 2028076 (Del. Ch. May 24, 2011). However, a standalone fairness opinion from a second investment banker is sometimes employed to alleviate any concern. It is debatable whether the buyer could then use the same advisor with respect to actual post-deal appraisal litigation.