Appraised Value Rights

A Summary for Investors

This review of appraisal rights is intended to provide professional fund managers with a foundation for considering practical investments in the intrinsic value of buyout companies as an alternative to market-based offer prices. Requests for additional information will be welcomed.

- ## Starting with an ideal theory

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Starting with an ideal theory

What appraisal rights are

The purpose of appraisal rights established by corporate laws in Delaware and most other states is to assure that investors can actually get what a corporation promises to give them in exchange for capital: a share of the long term enterprise. The logic of the rights is simple:

A. A stockholder must have a secure right to receive a share of a corporation's long term enterprise value in exchange for a contribution of capital.

B. Since a corporation can be sold at any price that is acceptable to willing sellers of a majority of shares, the ***un***willing sellers must have some way to realize the fair value of their long term enterprise investment.

C. The value to long term enterprise investors must be determined independently of what the willing sellers agreed to accept from a currently willing buyer.

…and what they are not

≠ In spite of what you might hear from litigation enthusiasts, appraisal rights are not a remedy for unfair pricing of a buy-out. Unwilling sellers have a right to be paid a court's independent determination of long term enterprise value whether the buyout price for willing sellers was fair or not. There is no need to prove that anyone behaved badly.

≠ Unfortunately, appraisal rights are also not easy to manage. The procedures were established by Delaware in 1899, and little had been done until recently to adapt the provisions to modern investment practices. This has naturally discouraged wide use, so that even most lawyers are unfamiliar with the process or what is relevant to valuation, and many advise their clients to avoid the confusing process.

Viewing appraisal rights as practical investments

Investor decisions about appraisal rights can be viewed in three phases, whether managed in the traditional litigation process or in the recently developed process for marketable investments (see the concluding section on "Managing Rights as 'AVR' Investments"):

Step #1. Reserving rights to choose alternatives – Owners of a company's stock can reserve the right to appraisal by presenting a demand before the vote on the proposed buyout. The investor can drop that demand by selling the stock before the effective date of the transaction, or for 60 days after that date by withdrawing the demand. No commitments or costs are involved other than nominal administrative expenses.

Step #2. Choice between offered price and appraisal rights – The investor has up to 60 days after the effective date of a buyout transaction to decide whether the risk-adjusted present value of appraisal rights is greater than the offer price. Decisions about managing the rights are usually made at this time, but can be deferred.

Step #3. Continuing evaluation – Investors using traditional litigation management can consider settlement offers prior to the court determination of value; those holding rights as marketable investments can evaluate and consider broader buy-sell alternatives.

Two ways to generate alpha

Difference between market pricing and intrinsic value

The stock of a buy-out company is priced by the current market of willing sellers and willing buyers, while appraisal rights provide a payment based on a company's "intrinsic value" (plus interest accruing at 5% over the Fed discount rate).

- If you're a **value investor**, just do what you always do to analyze the difference between current market pricing and an independently determined intrinsic value.
- If you're a **passive investor**, just follow your usual disciplined logic in selecting the type of conditions – for example, buyouts by management insiders partnering with private equity professionals – supported by statistical probabilities of positive results.

Difference between informed analysis and misperception

Since traditional management of appraisal rights has discouraged its use, most investors as well as most advisors are unfamiliar with how it works. This creates significant opportunities for investors who understand the process.

- You can usually buy stock in a buyout company from investors who are willing to sell at or below the proposed buyout price because they mistakenly believe a fair bidding process establishes the value for appraisal rights.
- Even when investors understand that the intrinsic value for appraisal rights is likely to be higher than the buyout price, they often decide not to seek appraisal rights because they view it as litigation and are unaware of alternatives to manage the rights efficiently as a marketable investment.
- Investors relying upon traditional litigation management of appraisal rights may be willing to sell their interests for significantly less than the value that can be established by managing the rights as marketable investments, providing liquidity alternatives as well as the ability to price and hold the rights in a regulated fund.

Suggested reading

- ***Valuation standards***: September 9, 2013, Jeremy D. Anderson, Erin C. E. Battersby and José P. Sierra of Fish & Richardson P.C., memorandum to Dell Valuation Trust: Delaware Appraisal of Fair Value for Standalone Buyouts, summarized in September 10, 2013 *New York Times* DealBook: "Icahn's Last Chance on Dell" and September 10, 2013 Forum Report: Court Rules for Appraisal: Fair Value = Intrinsic Value
- ***Evolving investor market***: October 3, 2013 *Bloomberg*: "Dell Value Dispute Spotlights Rise in Appraisal Arbitrage" and October 31, 2013 *Wall Street Journal* MoneyBeat: "Dole Food Deal Passes By Slim Margin as Hedge Funds Seek Appraisal"
- ***Practices for realization of intrinsic value***: October 14, 2013 Forum Report: Panel to Consider Appraisal Rights Policies for Long Term Investment

Managing Rights as “AVR” Investments

Traditional appraisal rights can be adapted to the needs of a fund manager who wants to hold – or buy and sell – a marketable investment in a regulated portfolio. The basic requirements of an “Appraised Value Rights” (“AVR”) investment are the same as for other asset investments:

- **Independent servicing** – An independent “AVR Manager” coordinates administrative and legal services on behalf of all participating investors, assuring equal treatment of the interests and shielding the investors from exposure to confidential information.
- **Independent reporting** – A “Review Panel” of investor delegates or similar group of representatives who can accept confidentiality obligations confers with legal counsel and conducts other research as required to (a) guide the valuation proceedings and (b) provide investors with public reports of quarterly progress and major developments.

Following is a comparison of traditional litigation and marketable “AVR” management.

	Traditional Litigation Management	Marketable “AVR” Investment Management
Investor interest	Investor acts as petitioner for direct management of its rights to payment determined by court	Investor owns independently administered rights to payment determined by court
Legal representation	Must engage Delaware counsel to represent petitioner	Investors are represented by counsel for AVR Manager’s nominal petitioner; engagement of own counsel optional
Court appearance	Must appear as petitioner	Investors not identified unless grant permission; optional support for any investor wanting to appear as petitioner
Support of valuation	Counsel engages expert to present views of value for court consideration	Review Panel of investor delegates guides counsel selection of experts and provides reports for court consideration
Funding	Negotiable legal fees, typically contingent; petitioner responsible for non-contingent expert and court fees	The AVR Manager funds all costs, subject to deduction from ultimate distributions
Settlement	Controlled by lead petitioner	Each AVR investor free to negotiate independent settlement or sale
Information access	Private reports of petitioner’s counsel on progress of engagement; optional use of independent services for copies of court filings	Independent public reporting of quarterly progress and major developments, participant access to Review Panel for questions
Liquidity	Limited to settlement or assignment of petitioner rights; marketability restricted by confidentiality or privilege of investor information from attorneys	Can sell at any time, either to settle or in private trading of identical units based on independently reported information; publicly listed trading if justified by size and nature of AVR
Pricing	“Level 3” asset valuation estimates	Minimum “Level 2” market pricing, possible “Level 1” if size and nature of AVR justifies public registration