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Merion We Roll Along
Appraisal Arbitrage at a Crossroads?

BY HOWARD O. GODNICK AND BRIAN BURNS

Two cases currently pending in the Delaware Court of Chancery have the potential to meaningfully impact the growing practice of ''appraisal arbitrage,'' the practice of purchasing shares in the target of a merger or acquisition solely or primarily for the purpose of asserting appraisal rights—the rights of an investor, in lieu of receiving the deal price, to petition a court for a determination of the ''fair value'' of the investor's shares. Firms that engage in appraisal arbitrage often establish their positions in the target company's stock after a deal is announced, and sometimes even after the record date for voting on the deal has passed. Since May, however, at least two companies have challenged the standing of appraisal petitioners who purchased their shares after the record date, contending that those petitioners could not prove the shares they owned voted ''no'' or abstained from voting on the merger, a prerequisite for asserting appraisal rights. The outcome of those two cases could dramatically impact the future of appraisal arbitrage.

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Both cases—*In re Appraisal of Ancestry.com, Inc.*[1] and *Merion Capital LP v. BMC Software, Inc.*[2]—involve Merion Capital LP, one of the more prominent appraisal arbitrage firms. In the last five years, Merion has filed at least ten appraisal petitions in the Delaware Court of Chancery and in late 2013 reportedly raised $1 billion for an appraisal-dedicated fund. The issues in *Ancestry.com* and *BMC* arose after Merion purchased shares of both companies after the respective record dates and then sought appraisal. In May, just weeks before a full trial on the merits, Ancestry.com filed a motion for summary judgment against Merion, arguing that because Merion purchased its shares after the record date and admittedly did not know how the shares were voted, Merion could not meet its burden of proving its entitlement to appraisal.[3] In late July, BMC filed a similar motion against Merion. The main difference between the cases is that in *Ancestry.com*, Merion filed its petition as a beneficial owner of Ancestry.com stock,

[1] Consol. C.A. No. 8173-VCG (Del. Ch.).
[2] Consol. C.A. No. 8900-VCG (Del. Ch.).
[3] The case has since gone through trial and the parties have submitted post-trial briefing on the merits.

while it filed its petition in *BMC* as the record owner of the stock.

Depending on how Vice Chancellor Glasscock (before whom both cases are pending) decides the issues, that difference may be important. In *In re Appraisal of Transkaryotic Therapies, Inc.*[4], the Delaware Court of Chancery held that a beneficial owner who purchased shares after the record date need not prove that those particular shares were not voted in favor of the merger. Instead, the court explained, the actions of the record holder were what mattered. Fine for BMC, but not so helpful for Ancestry.com. Ancestry.com, however, is arguing that the Delaware legislature took critical action after the *Transkaryotic* decision. In 2007, after *Transkaryotic* was decided, the appraisal statute was amended to allow beneficial owners to file petitions directly for appraisal,[5] which, according to Ancestry.com, had the effect of placing on the beneficial owner the obligation to show how its shares were voted. A contrary conclusion, Ancestry.com argues, could lead to the impermissible result of more shares being entitled to appraisal than shares not voted in favor of the merger.

Whatever the outcome of the two cases, they have the potential to impact the growing industry of appraisal arbitrage, perhaps by encouraging other would-be appraisal arbitrage firms to get involved, or by erecting certain obstacles to the practice. The remainder of this article looks at the growth in appraisal proceedings, the considerations relevant to bringing an appraisal petition, and the potential impacts and responses to decisions in *Ancestry.com* and *BMC*.

The Growth in Appraisal Proceedings

Appraisal proceedings in recent years have been growing in number, frequency, and value. In other words, as the overall number of appraisal cases has increased, so too have the percentage of deals attracting appraisal petitions and the dollar value of the shares at issue in the cases. Although not nearly as ubiquitous as the typical breach of fiduciary duty litigation relating to pending M&A deals, the growing number of appraisal cases is significant, especially in light of the substantial commitments of time, money, and resources required to see an appraisal case through trial. The growth is also significant because it is happening in part at the hands of repeat players, with a number of firms filing multiple appraisal petitions in multiple deals over the past few years.

A variety of explanations have been offered to explain this recent trend. It has been attributed in part to the *Transkaryotic* decision and the additional time that decision afforded potential petitioners to assess their possible appraisal investments (thus giving opportunistic funds more time to pore over the target company's financials, projections, and public filings). It has also been attributed to the statutory interest rate (described below) and to the growth in M&A litigation generally. While there may not be a single, easy explanation for the growth in appraisal cases, we see it as a product of entrepreneurial firms finding success with a previously lesser-used strategy supported by an existing statutory framework (that arguably was not designed with this sort of practice in mind) and attracting others to the fold in the process. As new firms begin to undertake the practice, there are some basic considerations about the appraisal process that any firm contemplating such an investment should understand. We discuss some of those below.

Relevant Considerations

The decision to file a petition for appraisal should involve a careful consideration of the potential costs, risks, and benefits of the process, including the following.

Appraisal Can Be a Lengthy Process. Appraisal cases typically can last two to three years between the filing of the petition and the post-trial decision, with longer periods not uncommon. While an appraisal case is pending, an appraisal petitioner holds an illiquid claim and is essentially an unsecured creditor subject to the credit risk of the surviving company (which may have taken on substantial debt to finance the acquisition). And as time passes, appraisal petitioners who wish to bow out of a case and receive the deal proceeds may find themselves unable to do so. That is because after 60 days from the effective date of the merger, the corporation's written approval is required for a shareholder to withdraw its appraisal demand, and the corporation is under no obligation to provide that approval.[6] Thus, appraisal petitioners could find themselves and their (and their investors') funds essentially locked-up in a lengthy proceeding involving significant credit risk, without the protection of the deal price or any other simple, readily-available liquidation strategy to fall back on.

Appraisal Can Be an Expensive Process. Appraisal petitioners must bear the cost of legal fees, discovery expenses, expert witness fees, and other costs. Unlike in typical class action litigation, appraisal petitioners generally cannot shift the costs of attorneys' fees or expert witness fees to the company.[7] While attorneys' fees may be shifted to the respondent company in the event of, for example, serious bad faith litigation conduct, this is rare.[8] The court can, however, order that the costs be shared among all the shares seeking appraisal.[9] One

[4] No. C.A. 1554-CC, 2007 WL 1378345 (Del. Ch. May 2, 2007).

[5] Prior to the 2007 amendments to the appraisal statute, such actions could only be brought by the record owner of the shares, which, most often, was Cede & Co., the nominee for the Depository Trust Co. ("DTC"). As discussed below, DTC holds a large number of publicly traded shares and nominates Cede as the record holder of those shares. Prior to the 2007 amendments, the ultimate beneficial owners of those shares were thus required to rely on Cede—as the record owner—to file appraisal petitions on their behalves.

[6] *See* 8 Del. C. § 262(k); *Dofflemyer v. WF Hall Printing Co.*, 432 A.2d 1198, 1201 (Del. 1981); *Cede & Co. v. Technicolor, Inc.*, 1987 BL 660, at n.1 (Del. Ch. Jan. 13, 1987).

[7] *See, e.g., Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 301 (Del. 1996) ("In the absence of an equitable exception, the plaintiff in an appraisal proceeding should bear the burden of paying its own expert witnesses and attorneys.").

[8] *See Montgomery Cellular Hldg. Co. v. Dobler*, 880 A.2d 206, 227-29 (Del. 2005) (shifting attorneys' fees where respondent company destroyed computers after the court ordered them produced and where the controlling stockholder of the company lied under oath).

[9] 8 Del. C. § 262(j).

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way potential appraisal petitioners can assess whether the possible costs of an appraisal proceeding are likely to make economic sense is to take advantage of the provision in the appraisal statute that allows dissenting shareholders to request from the corporation a list of the total number of shares demanding appraisal and the number of holders of those shares.[10] This list need not include the names of the shareholders (either the record holders or the beneficial holders), but it can provide a sense of the scale of any potential appraisal proceeding and the field across which the costs of the proceeding may be spread (and potential leverage in connection with settlement talks). On the other hand, for potential petitioners with large enough stakes in the target company and enough conviction in their valuation analyses, the universe of other dissenting shareholders may not be a particularly relevant consideration. These potential petitioners may well be willing to pursue an appraisal proceeding as the lone petitioner if the situation demands it. In *BMC*, for example, Merion Capital filed its appraisal petition just days after the closing of the deal and was the only shareholder to seek appraisal.

Appraisal Proceedings Can Be Lucrative. The Delaware Court of Chancery frequently has held that the ''fair value'' of shares in an appraisal proceeding was higher—sometimes significantly higher—than the deal price.[11] The disparity between the ''fair value'' and the deal price generally has been greatest in ''interested'' transactions, such as those involving a controlling shareholder or parent-subsidiary merger. There is of course a risk that the court will appraise the fair value of a petitioner's shares at less than the deal price, a risk that is heightened in cases involving arm's-length mergers that were subject to significant market checks.

Appraisal Petitioners Are Entitled to Interest. Shareholders who take their appraisal cases to final judgment enjoy a statutory right to interest on the ''fair value'' of their shares, measured from the effective date of the subject transaction to the date of payment of the appraisal judgment. The statutory interest rate in Delaware appraisal cases is 5 percent over the Federal Reserve discount rate.[12] This interest rate—and its potential effects on the incentive structure in appraisal cases—has garnered comments from Delaware judges and others. Vice Chancellor Glasscock, for instance, has expressed a ''general concern about whether the interest rate that the Legislature has set encourages these type of appraisal cases and would also encourage or incentivize a slow walk toward the finish line.''[13] Vice Chancellor Laster, on the other hand, has referred to the ''uninformed commentary'' about the appraisal statute interest rate, explaining that the interest rate was not designed to be equivalent to the rate in a savings account, but instead, to take into consideration that the shareholder had been ''forcibly eliminated from an equity investment'' and that the company was obtaining the ''benefit of the stockholder's capital,'' making the interest rate more akin to that of a corporate bond.[14] For any potential appraisal petitioner, the attractiveness of the interest rate should be balanced against the time and risks inherent in pursuing active—and expensive—litigation through trial and against the notion that, for a sophisticated financial institution, a five percent return is, according to some, simply not good enough to stay in business. For companies concerned about the potential interest obligation, one possible solution is to offer the appraisal petitioner a prepayment of an amount the company believes to be an undisputed amount of ''fair value'' for the shares. While this would stop the accrual of interest if the petitioner voluntarily accepted the offer, a court likely will not compel the petitioner to accept the prepayment.[15]

Appraisal Petitioners Do Not Need to Prove Any Wrongdoing by the Corporation or Its Board. Unlike in the usual breach of fiduciary duty M&A litigation, an appraisal petitioner need not prove any wrongdoing by the corporation or its board of directors. This means that shareholders who properly perfect their appraisal rights and are prepared to pursue their case through trial bear little risk of being left with nothing in the event of a less than favorable ruling from the court. They do risk, of course, the possibility that the court's fair value determination is less than the deal price.

These are some of the basic considerations underlying appraisal litigation. The *Ancestry.com* and *BMC* cases, however, have the potential to impact the appraisal calculus, which we discuss below.

Potential Impact of Ancestry.com and BMC

A Decision in Favor of the Target Companies. A decision in favor of the respondent, target companies in *Ancestry.com* or *BMC* likely means a decision requiring post-record date purchasers to prove that they own shares not voted in favor of the merger. While such a decision may provide complications to the practice of appraisal arbitrage because of the way shares are held in today's securities markets (described below), it does not necessarily signal an end to the practice. To the contrary, as Ancestry.com itself points out in its briefs, there may be ways for a firm to purchase shares after the record date and still ensure that those shares are not voted in favor of the merger. Ancestry.com identifies two related methods: acquire proxies from the previous beneficial owners, or secure the revocation of proxies that may have been granted by parties who owned shares as of the record date.

In practice, however, obtaining proxies or the revocation of proxies may not be so easy. That is largely because of the way shares are typically held in today's securities markets. A very large number of shares of publicly traded companies are held as of record by Cede & Co., the nominee of the Depository Trust Corporation

[10] *See* 8 Del. C. § 262(e).

[11] *See* Jesse A. Finkelstein & John D. Hendershot, *Appraisal Rights in Mergers and Consolidations*, B.N.A. Portfolio 38-5, at B-1801-08 (2013) (chart of appraisal decisions comparing ''fair value'' determinations to merger price).

[12] 8 Del. C. § 262(h).

[13] *In re ISN Software Corporation Appraisal Litigation*, Consol. C.A. 8388-VCG (Del. Ch.) (Transcript dated Sept. 26, 2013), at p. 18.

[14] *Kettleton Multi-Year Hldgs. LLC v. Sourcefire LLC*, C.A. No. 9157-VCL (Del. Ch.) (Transcript dated Apr. 25, 2014) at 15-17.

[15] *See Huff Fund Investment P'ship v. CKx, Inc.*, C.A. No. 6844-VCG, 2014 BL 38324, at *1-3 (Del. Ch. Feb. 12, 2014) (declining to compel appraisal petitioner to accept prepayment in order to stop accrual of interest).

(''DTC''). DTC holds shares on behalf of banks and brokers (known as ''participants'' in DTC), and the banks and brokers in turn hold the shares on behalf of their customers, the ultimate beneficial owners of the stock. Both DTC and its participants hold the shares in a manner known as ''fungible bulk,'' which means that no beneficial owner or participant has any claim or ownership rights in any particular shares and that sale transactions cannot be matched between particular beneficial buyers and sellers.

With shares held in this manner, the ultimate beneficial owners are not the record or registered owners of the stock, and they therefore do not have the legal authority to vote the shares or grant a proxy allowing another person to vote the shares for them. Instead, DTC/Cede, as the record owner, possesses that authority. Since DTC/Cede has no beneficial interest in the shares, however, it passes the authority on to its bank and broker participants through an ''omnibus proxy.'' The beneficial owners can then give instructions to their bank or broker on how they would like to vote, but the actual proxy authority generally is not transferred down to the beneficial owners, unless the beneficial owner obtains a ''legal proxy'' from its bank or broker that formally confers the authority on the beneficial owner.

This is the complicated context in which these potential ''workarounds'' to a decision in favor of Ancestry.com or BMC are likely to take place. According to one treatise, to obtain a proxy in connection with a post-record date purchase:

The purchaser must identify the beneficial owner of a large block of shares, contact the beneficial owner directly and negotiate the sale. Because the beneficial owner selling the shares is not the ''holder of record,'' it does not have the authority to grant an irrevocable proxy. Therefore, it must first obtain a ''legal proxy'' from its custodian giving it the power to grant an irrevocable proxy to the purchaser. Because this process is cumbersome, contestants are advised to endeavor to acquire as many shares as possible in advance of the record date.[16]

Thus, the approach of acquiring proxies after the record date—while apparently feasible—is by no means a turn-key solution.

Interestingly enough, there is case law in Delaware suggesting—outside the appraisal context—that a post-record date purchaser would have a right to compel the seller to grant a proxy.[17] But given the manner in which shares are held today and the inability to match specific sellers with buyers in open market transactions, this right may not prove to mean much in practice.

Apart from obtaining proxies, another potential ''workaround'' to a decision in favor of Ancestry.com could seemingly be a return to the practice of having Cede & Co., as the record owner, file the appraisal petition on behalf of the post-record date beneficial purchaser. That was the basic factual set-up in *Transkaryotic*, and in the *Ancestry.com* case, Merion in fact asks the court to allow it to substitute Cede as the petitioner in the event the court rules that Merion lacks standing. But that solution—according to Ancestry.com—does not cure the problem that, because of the 2007 amendment allowing beneficial owners to file appraisal petitions, more shares could conceivably be ''entitled'' to appraisal than were voted against or abstained from voting on the merger.

A Decision in Favor of Merion. A decision in favor of Merion, on the other hand, absolving petitioners of any obligation to ''trace'' their shares to specific votes, could provide a measure of encouragement to firms considering whether to join the appraisal arbitrage field. To the extent that a decision in *Ancestry.com* or *BMC* is seen as removing or limiting the potential risk of litigation relating to threshold entitlement-to-appraisal issues, it could be a catalyst to firms considering whether to engage in the practice. Fewer issues to litigate, after all, presumably means lower costs and a faster path to trial.

A decision in favor of Merion could also embolden the already echoing calls for a legislative response limiting in some way the practice of appraisal arbitrage—whether by requiring beneficial holders who file petitions to have owned their shares prior to the record date or requiring them to obtain proxies as described above or by some other means. The argument here is largely that the practice of appraisal arbitrage is inconsistent with the purposes underlying the appraisal remedy. Historically, major corporate transactions required unanimous shareholder approval. When that rule proved unworkable, legislatures provided dissenting shareholders with appraisal rights as a measure of concession for their loss of veto power. As the Court of Chancery explained in *Transkaryotic*, the ''primary purpose'' of the appraisal statute ''is to protect the contractual rights of shareholders who object to a merger and to fully compensate shareholders for any loss they may suffer as a result of a merger.''[18] Affording appraisal rights to shareholders who buy-in to the company on the eve of a merger for the sole purpose of seeking appraisal, the argument goes, is inconsistent with the purpose of protecting shareholders who invested in the company as a going concern. The Court in *Transkaryotic* recognized that the solution to this ''evil, if it is an evil,'' lay with the legislature.[19] So far, however, no legislature of which we aware has taken action to limit appraisal arbitrage.

Conclusion

Appraisal proceedings and the practice of appraisal arbitrage are no doubt growing, and the pending decisions in *Ancestry.com* and *BMC* could have a meaningful impact on the practice. Whatever the outcome, the practice is unlikely going away in the immediate future, and careful consideration of the risks, benefits, and costs of any appraisal proceeding should be at the forefront of any potential appraisal petitioner's business or legal strategy.

[16] John C. Wilcox, John J. Purcell III, and Hye-Won Choi, *''Street Name'' Registration & the Proxy Solicitation Process*, § 12.5[1], at 12-18, *available at* http://www.sec.gov/comments/4-537/4537-25.pdf.

[17] *See Commonwealth Associates v. Providence Health Care, Inc.*, 641 A.2d 155, 155–58 (Del. Ch. 1993); *Len v. Fuller*, No. Civ. A. 15352, 1997 WL 305833, at *3 (Del. Ch. May 30, 1997).

[18] *See Transkaryotic*, 2007 WL 1378345, at *3.

[19] *Id.* at *5.

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