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July 11, 2014

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SHAREHOLDER APPRAISAL PROCESS IN DELAWARE

When certain corporate transactions, such as a merger and consolidation, deprive the shareholders of their ownership interests in a corporation against their will, the shareholders can use the appraisal statutes to obtain the "fair value" of the shares that have been taken.¹ As more than half of U.S. public companies are incorporated in Delaware, the Delaware General Corporation Law (the DGCL) is likely to govern most shareholders seeking appraisal.² Section 262 of the DGCL provides appraisal rights to dissenting shareholders who own shares in a corporation that is the subject of a merger or consolidation effected pursuant to the DGCL. Such rights are typically available only in a merger in which the holders of the shares of the merged entity receive cash in return for their shares.³

This alert provides an overview of the appraisal process under Delaware law and explains a number of recent developments that have contributed to the increasing use of appraisal rights.

Appraisal Process

Although the rights and obligations of shareholders and companies will vary depending upon the circumstances of the particular merger, the appraisal process under Section 262 of the DGCL generally proceeds as follows⁴:

- If a proposed merger or consolidation for which appraisal rights are provided under Section 262 is to be submitted for approval at a shareholder meeting, the subject company must give notice of the availability of appraisal rights to its shareholders at least 20 days prior to the meeting.⁵ The notice must include a copy of Section 262 for the shareholders to review.⁶
- A dissenting shareholder who desires to exercise appraisal rights must (a) not vote in favor of the merger or consolidation⁷; and (b) continuously hold the shares of record from the date of making the demand through the effective date of the applicable merger or consolidation.⁸ Further, the dissenting shareholder must deliver a written demand for appraisal to the company before the vote is taken.⁹
- Within ten days of the effective date of the merger or consolidation, the surviving company must notify all shareholders who properly delivered an appraisal demand that the merger or consolidation has become effective.¹⁰
- Within 120 days after the effective date of the merger or consolidation, the surviving company or any dissenting shareholder who has properly demanded appraisal and otherwise complied with the requirements of Sections 262(a) and (d), may commence an appraisal proceeding by filing a petition in the Delaware Court of Chancery demanding a determination of the value of the shares held by all such shareholders.¹¹
- Through the proceeding, the court will determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger, together with interest, if any, to be paid upon the amount determined to be the fair value.¹² In determining such fair value, the court will take into account

"all relevant factors."¹³ Unless the Delaware Court of Chancery in its discretion determines otherwise, interest from the effective date of the merger through the date of payment of the judgment will be compounded quarterly and accrue at 5% over the Federal Reserve discount rate (including any surcharges).¹⁴

- After a hearing on the petition, the Delaware Court of Chancery will determine which dissenting shareholders are entitled to appraisal rights.¹⁵
- The cost of the appraisal proceeding may be determined by the Delaware Court of Chancery and taxed upon the parties as the court deems equitable.¹⁶ Upon application of a shareholder, the Delaware Court of Chancery may order that all or a portion of the expenses incurred by such shareholder in connection with the appraisal proceeding, including, without limitation, reasonable attorneys' fees and the fees and expenses of experts, to be charged pro rata against the value of all shares entitled to an appraisal.¹⁷

Increasing Use of Appraisal Rights

There has been a growing tendency of institutional and other large investors to exercise their appraisal rights under Delaware law. Investors in several recent mergers sought to exercise their appraisal rights, including in deals involving Dell, Dole Food Company and 3M Cogent. In addition to the courts' flexible approach to valuation of "fair value," the following developments in recent years have contributed to the increasing use of appraisal rights.

- As cash represents the deal currency in a majority of domestic M&A transactions over the last few years, the deals in which appraisal rights apply have increased.
- With a significant increase in capital available to hedge funds dedicated to activists, appraisal rights have become an interesting new opportunity to deploy capital. Appraisal rights are also attractive because the benefits of such actions are shared only among the shareholders who participate in such actions.
- Under Section 262(h), shareholders are generally entitled to interest on the appraisal award at a rate equal to the Federal Reserve discount rate plus 5% (compounded quarterly) from the effective date of the merger through the date of payment of the judgment. This interest is paid regardless of the ultimate appraisal decision. The accumulating interest payments can offset litigation costs imposed on the dissenting shareholders throughout the proceeding and extended period of illiquidity.

Factors to Consider Before Seeking Appraisal

Shareholders seeking appraisal under Delaware law must know that the appraisal process can take a considerable amount of time and expense. Some exposure to production of documents and to depositions is likely. They should also be aware of the risks that the Delaware courts will take various approaches to determine "fair value" and that the appraised value can be less than the consideration offered to shareholders in the merger. Further, the amount of interest, if any, awarded on the appraised value is uncertain until the valuation process is over.

However, in circumstances where the facts clearly show that the merger price was not determined on arm's length terms, dissenting shareholders can recover substantially more than the consideration offered to them. Also, the appraisal remedy does not involve any claim of wrongdoing, but focuses on determining the value of the shares. This can make appraisal litigation less time-consuming, expensive and onerous than litigation, in which the primary goal is to prove a defendant's wrongdoing.



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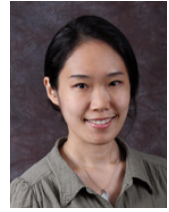
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¹ Jay W. Eisenhofer & Michael J. Barry, Shareholder Activism Handbook (2013) [hereinafter Handbook].

² Other states have adopted the Model Business Corporation Act (MBCA).

³ Handbook.

⁴ Section 262 of the DGCL is available at <http://delcode.delaware.gov/title8/c001/sc09/>.

⁵ Del. Code tit. 8, § 262(d)(1).

⁶ Id.

⁷ § 262(a).

⁸ Id.

⁹ § 262(d)(1).

¹⁰ Id.

¹¹ § 262(e). If no petition for an appraisal is filed within the 120-day period, or if such dissenting shareholder delivers to the surviving company a written withdrawal of the shareholder's demand for an appraisal and an acceptance of the merger or consolidation, either within 60 days after the effective date of the merger or consolidation (or thereafter with the written approval of the corporation), then the dissenting shareholder's right to appraisal will cease. § 262(k).

¹² § 262(h).

¹³ § 262(h). The Delaware courts have held that "fair value" is the company's value as a going concern (i.e., excluding merger-specific value). However, in a recent decision by the Delaware Court of Chancery, the court held that under certain circumstances, the best indicator of a shareholder's shares was the merger price generated by an arm's length sales process. Huff Fund Investment Partnership v. CKx, Inc., C.A. No. 6844-VCG (Del. Ch. Nov. 1, 2013). In CKx, the Vice Chancellor highlighted the rationale in Golden Telecom, Inc. v. Global GT LP that the court has an obligation to consider all relevant factors, and that no per se rule should presumptively or conclusively exclude any of those factors from consideration. See Golden Telecom, Inc. 11 A.3d 214 (Del. 2010). While the courts must take into account "all relevant factors" in determining fair value, they may consider a broad range of valuation methods, including, but not limited to, discounted cash flow, Delaware block method, comparable company valuations, and comparable transactions valuation. Since Weinberger v. UOP, Inc., the courts, however, have come to favor the discounted cash flow method. See Weinberger v. UOP, Inc., 457 A.2d 701, 702 (Del. 1983).

¹⁴ § 262(h).

¹⁵ § 262(h)(i).

¹⁶ § 262 (j).

¹⁷ Id.