

Proposed Appraisal Statute Amendments Would Permit Companies to Reduce Their Interest Cost—Likely To Discourage “Weaker” Appraisal Claims and Make Settlement of “Stronger” Claims Harder

Proposed amendments to the Delaware appraisal statute announced last week are expected to be adopted by the Delaware Legislature. The stated purpose of the amendments is to reduce the recent rise in the volume of appraisal petitions. If adopted, the amendments would apply to merger agreements entered into on and after August 1, 2015.

The proposed amendments.

- **Option for companies to reduce interest cost (the “Interest Reduction Amendment”).** This Amendment would provide an option for a company in an appraisal proceeding to pay a cash amount to the dissenting shareholders before the appraisal proceeding ends (an “Upfront Payment”). Statutory interest would accrue thereafter only on the unpaid portion of the ultimate appraisal award. The Upfront Payment would presumably be non-refundable, as there is no claw-back mechanism provided in the proposed amendment for a company to recoup any amount paid out that turns out to have exceeded the ultimate appraisal award.
- ***De minimis* exception to appraisal rights (the “*De Minimis* Amendment”).** This Amendment would create a *de minimis* exception to appraisal rights. Appraisal petitions would be dismissed if the shares seeking appraisal were traded on a national securities exchange and (a) the value of the merger consideration applicable to the shares seeking appraisal is less than \$1 million or (b) the shares seeking appraisal represent less than 1% of the total outstanding shares of the class entitled to appraisal rights. The threshold minimums would not apply in the case of appraisal following a short-form merger (since appraisal may be the only remedy available to dissenting shareholders in a merger in which there is no stockholder vote).

Background.

- **CKx decision on tolling.** The Interest Reduction Amendment would override a recent Chancery Court decision, affirmed by the Delaware Supreme Court, which held that, under the current appraisal statute, the court does not have the authority to toll the statutory interest during the appraisal proceeding by making a partial prepayment to dissenting stockholders. In *CKx*, the company sought to make a payment of the undisputed portion of the appraisal

amount after the court had determined “fair value” but had extended the proceedings to permit the parties to submit arguments as to whether any appropriate adjustments to the amount.

- **“Interest arbitrage”.** There has been a concern that a significant portion of appraisal petitions are motivated primarily or even exclusively by the interest factor itself (so-called “interest arbitrage”). Companies are required by statute to pay interest on an appraisal award at a rate equal to 5% above the Federal Reserve funds rate, compounded quarterly, accruing from the effective date of the merger to the date of payment of the appraisal award after conclusion of the appraisal proceeding. The statutory interest rate is significantly above the regular interest rate payable on deposited funds. Indeed, the interest on an appraisal award can itself represent a significant additional premium above the merger price (see the Chart below) and undoubtedly has been a factor in the calculus relating to the bringing and settlement of appraisal claims. The interest factor has encouraged appraisal petitions by (i) guaranteeing a perceived above-market return during the substantial period before an appraisal award is determined and received, (ii) cushioning against the risk of an ultimate appraisal determination that is below the merger price, and (iii) funding a reimbursement of the costs of the appraisal proceeding.

Notably, however, the statutory rate in appraisal cases is the same rate as applies in other Delaware litigations. The Chancery Court, in *CKx*, while acknowledging that the risk of “rent-seeking” is higher in appraisal cases than in at-fault litigation, noted that the purpose of the interest on an appraisal award is not to provide a market rate of return on cash (i.e., conventional interest) but to compensate for the loss of a return that could have been obtained by having had the funds available to invest, as well as the credit risk associated with appraisal litigation. The court distinguished the low market interest rates associated with *risk-free* returns from the higher rates that would be appropriate to compensate for the loss of use of capital and credit risk in appraisal litigation.

In any event, and most critically, in our experience, interest does not appear to be an important motivating force behind “strong” appraisal petitions. In these cases, the primary motivation is the potential for a “bonanza”-type appraisal award. The interest awards in these cases tend to be large *because* the appraisal award is so large. We note that the high interest provided by the statute is still significantly below the target rate of return for hedge funds, which tend to be the most frequent appraisal arbitrageurs (i.e., parties that view appraisal claims as an investment, buying shares after announcement of a merger for the purpose of making an appraisal claim). Even the white paper released in connection with the proposed Amendments states that there is no empirical evidence suggesting that interest arbitrage is prevalent. Accordingly, the proposed Amendments do not include any reduction in the statutory interest rate.

Conclusions.

- **Additional flexibility for companies in appraisal proceedings.** The Interest Reduction Amendment provides *companies* with the right to decide whether, when, and in what amount to make an Upfront Payment. Although companies hoped for legislative action that would more directly and fully limit appraisal claims (and the rise of “appraisal arbitrage”—i.e., shares being acquired after announcement of a merger for the purpose of making an appraisal claim), the

added flexibility that would be provided to companies from the Interest Reduction Amendment should somewhat advantage companies in the appraisal process, as they would have the option either to maintain the status quo or, if it would appear to be of benefit, to make an Upfront Payment.

- **Uncertainty as to consequences.** While certain effects of the Amendments seem more likely than others, there is considerable uncertainty in general as to how companies and petitioners would respond to the Amendments and what the practical impact in appraisal situations would be.
- **Likely to reduce the volume of “weak” appraisal claims.** We think it likely that the volume of “weak” appraisal claims would be reduced as a result of the proposed Amendments. Currently, “weak” claims may be made simply based on settlement value, calculated in large part as the present value of the merger price plus the statutory interest. Settled relatively quickly, the focus of these claims is the additional amount provided by the interest factor. We expect that in these situations a company generally would make a large Upfront Payment (representing a significant percentage of the merger price), effectively eliminating the economic value of a weak appraisal claim. In addition, the *De Minimis* Amendment would reduce weak claims as it excludes cases that do not attract much interest from potential dissenting stockholders. (By “weak” claims, we mean those that are made with respect to transactions that are *unlikely* to result in an appraisal award that is significantly higher than the merger price. The Chancery Court has tended not to award appraisal amounts significantly exceeding the merger price in cases where there was a third party arm’s length transaction with a robust sale process—see the Chart below and our memorandum, “New Activist Weapon: The Rise of Delaware Appraisal Arbitrage: A Survey of Cases and Some Practical Implications” (June 18, 2014)).
- **Not likely to reduce the volume of “strong” appraisal claims.** In our view, it is likely that “strong” appraisal claims would continue to be made at the same rate as currently—because the primary motivation for these claims is the potential for an appraisal award significantly higher than the merger price, not the interest factor. As noted, the interest awards in these cases tend to be large *because* the appraisal award is so large. (By “strong” claims, we mean those that are made with respect to transactions that are likely to result in an appraisal award that is significantly higher than the merger price. In our survey of appraisal decisions since 2010, we found that the Chancery Court awarded appraisal amounts significantly exceeding the merger price only in cases where there was an interested party transaction without a robust sale process—see the Chart below.)
- **May marginally reduce the volume of “marginal” appraisal claims.** Based on the same reasoning described above with respect to “weak” and “strong” claims, the Amendments may affect the volume of “marginal” claims, possibly somewhat reducing the weaker marginal claims. (By “marginal” claims, we mean those claims that are neither weak nor strong.)
- **May encourage more dissenting shares to be included in cases of “strong” appraisal claims.** Upfront Payments in appraisal cases would significantly reduce the risks for petitioners associated with bringing appraisal petitions. An Upfront Payment representing a large percentage of the merger price would result in petitioners having only limited capital at stake during the proceeding (providing an opportunity for a highly-leveraged yet low-risk investment with the potential for outsized returns on the limited capital invested); having only a minimal credit risk during that time; and being able to use the Upfront Payment from the outset to fund costs of

the proceeding. Thus, while strong cases would be brought anyway (as noted above), *if* companies develop a practice of making Upfront Payments that represent a large percentage of the merger price, then a larger number of dissenting shares may be included in cases with strong claims.

- **May make settlement of “strong” appraisal claims more difficult.** Currently, companies have an incentive to settle to avoid continued accrual of the above-market statutory interest payable to the petitioners; and petitioners have an incentive to settle to reduce the time they have to wait for a payment from the company. The larger the Upfront Payment made by the company, the more these incentives would be reduced, potentially making settlement more difficult and unlikely.

Issues Relating to Upfront Payments. A company’s decision whether, when, and in what amount to make an Upfront Payment will be complicated.

- **Factors to be considered.** An evaluation of numerous factors would have to be made.
 - **Economic benefit of reducing interest cost.** A company would need to determine the economic benefit of reducing the amount on which the statutory interest will have to be made, as compared to the economic benefit of holding all of the funds for the full period of the appraisal proceeding (based on the company’s cost of capital, access to capital, need for cash, and other factors);
 - **Strategic disadvantage.** A company would have to consider the strategic disadvantage to the company of providing a significant cash payment to the dissenting stockholders before the end of the appraisal proceeding that would reduce their capital at stake and credit risk and that could be used to fund their expenses; and
 - **Avoiding an overpayment.** A company would need to take into account the degree of confidence it has, and at what stage of the proceeding it has it, as to what the likely range of the ultimate appraisal award will be—so that the company does not pay more in the Upfront Payment than the amount ultimately awarded (since, as noted, any excess amount presumably would be forfeited).
- **Companies unlikely to make an Upfront Payment.** A company would be *unlikely* to make an Upfront Payment if its cost of debt is equal to or greater than the statutory interest rate; if the company is a credit risk; or if the company believes the payment would significantly facilitate or favor the petitioners’ case or make reaching a settlement more difficult.
- **“Weak” appraisal claims.** As noted above, in the event of a weak appraisal claim, we expect that, to reduce the interest cost and thus to eliminate the basis for the economic value of the claim, most companies generally would opt to make a large Upfront Payment.
- **“Strong” appraisal claims.** In the case of a strong claim, however, the balance of the advantages and disadvantages of making an Upfront Payment would be more complicated. Although there is an intuitive logic to a company’s making a large Upfront Payment to reduce the large interest cost, it may be that companies would make only a relatively small Upfront Payment in order to achieve some modest reduction in interest cost, while preserving leverage going forward with respect to settlement by not reducing the petitioners’ capital investment and risk as much. The decision as to the size of the Upfront Payment would, of course, be affected by

whether more than one Upfront Payment can be made during an appraisal proceeding (see below).

▪ **Timing of Upfront Payments.**

- **Deadline for filing of petitions.** Presumably a company would not want to make an Upfront Payment until after the deadline has passed for petitions to be filed—i.e., 120 days after the merger effective date.
- **Can multiple Upfront Payments be made?** As currently drafted, it is clear that an Upfront Payment can be made at any time during the appraisal proceeding. It is not clear, however, whether an Upfront Payment can be paid only once or multiple Upfront Payments can be made during the proceeding. Presumably the objective would be best served by allowing multiple payments in order to maximize the total Upfront Payment amount and to permit a company to make payments on a more informed basis as the proceeding progresses.

▪ **Determining amount of large Upfront Payment.** Since, as noted, any amount of the Upfront Payment that exceeds the amount ultimately awarded will presumably be forfeited, ideally a company wanting to make a large Upfront Payment would want the payment to be as close to the ultimate appraisal award as possible without exceeding it—not necessarily an easy exercise.

- **Use of merger price as a guide.** In the hypothetical example provided in the white paper discussing the Amendments, the company made an Upfront Payment equal to 75% of the merger price. While this may prove to be a reasonable guide, uncertainty arises because the court only infrequently relies on the merger price in determining appraised “fair value”, typically relying instead on discounted cash flow and comparables financial analyses, the results of which can (and often do) vary significantly from the merger price. (See our memorandum “Why Delaware Appraisal Awards Exceed the Merger Price” (Sept. 23, 2014).)

In addition, the appraisal statute mandates that value arising from the merger itself be excluded from appraised fair value--thus requiring that factors such as expected merger synergies and a control premium that are embedded in a merger price be “backed out”. To date, the court has not provided much guidance on the complex issues that arise in connection with these types of adjustments; thus, uncertainty arises from the potential that adjustments will be made and, if made, from the lack of clarity as to how they will be made.

- **Petitioners’ fair value argument.** A company would not want to prejudice its argument in the proceeding by making an Upfront Payment that exceeds the amount it is arguing represents fair value (even if the company believes that the appraisal award will significantly exceed that amount).

Changes *not* proposed.

- **No far-reaching changes.** The Amendments do not include any of the more far-reaching changes that have been advocated by companies and others seeking to limit the volume of appraisal claims and the prevalence of appraisal arbitrage, or to ameliorate the burden on the court of determining “fair value”, such as: a limitation on the types of transactions to which appraisal rights would be applicable; restrictions on the timing for filing an appraisal petition; a change in the definition of fair value; limiting appraisal rights to stockholders who owned their

shares before announcement of the merger; further requirements with respect to establishing that shares have not been voted in favor of the merger; or establishing a burden of proof on the parties (rather than the Chancery Court) to determine fair value.

- **Alternative of reducing the interest rate.** Some have advocated for the Legislature to reduce the actual rate of the statutory interest on appraisal awards. The approach now being considered—opting to permit tolling of the interest rather than reducing the rate of interest—reflects the view (as noted above, recently expressed by the Chancery Court in *CKx*) that a decision to seek appraisal is the result of having been involuntarily cashed-out of a preferred investment and should reflect the unsecured credit risk in an appraisal proceeding.

Critical appraisal developments.

The most critical recent development in the appraisal arena has been the Chancery Court's use of the merger price as the primary or exclusive factor in determining appraised fair value under certain circumstances. These circumstances are *limited*—i.e., when (a) the merger price represents a *particularly reliable* measure of fair value because the merger was an arm's length third party transaction with a robust sale process *and* (b) the results of the standard financial analyses would be *particularly unreliable* because of the absence of reliable projections (because they were not prepared in the ordinary course of business or the business circumstances are so unusual as to make any reasonable projection impossible) and the absence of sufficiently comparable companies or transactions. However, the Chancery Court has decided its last two appraisal cases involving third party mergers based primarily or exclusively on the merger price, and the Delaware Supreme Court has affirmed one of those decisions. (Of course, the court may over time expand the circumstances under which it would view the merger price as the best reflection of fair value.) In our view, the court's increased use of the merger price in determining fair value will not significantly discourage appraisal but will drive appraisal activity toward those deals that represent a high potential for an award significantly exceeding the merger price.

In our view, the proposed Amendments (like the courts' recent increased reliance on the merger price in determining fair value) will not significantly discourage appraisal overall so much as it will further drive activity toward strong appraisal claims—i.e., claims involving transactions that represent a high potential for awards significantly exceeding the merger price. As noted above, these transactions have been interested party transactions without a robust sale process, reflecting the Chancery Court's skepticism that the merger price represents fair value in these transactions. It remains to be seen how often interested party transactions will now be structured to meet the *MFW* process prescriptions for business judgment rule review in fiduciary duty litigation and, if so, to what extent that process would affect the court's determinations in appraisal cases.

All Appraisal Decisions Since 2010 Premium Over Merger Price Represented by Statutory Interest

Decision Date	Case	Premium over merger price represented by appraisal amount	Estimated additional premium over merger price represented by the statutory interest *	Number of years from merger date to appraisal decision
INTERESTED PARTY TRANSACTIONS				
5/12, 6/25/14	<i>Laidler v. Hesco</i>	86.6%	24.7%	2.5
9/18/13	<i>In re Orchard Enterprises</i>	127.8%	36.1%	2.0
6/28/13	<i>Towerview v. Cox Radio</i>	19.8%	26.9%	3.9
4/23/10	<i>Global v. Golden Telecom</i>	19.5%	14.7%	2.2
2/15/10	<i>In re Sunbelt Beverage</i>	148.8%	213.8%	12.4
THIRD PARTY TRANSACTIONS				
1/30/15	<i>In re ancestry.com</i>	0%	11%	2.1
11/11/13	<i>Huff v. CKx</i>	0%	12.7%	2.3
7/8/13	<i>Merion v. 3M Cogent</i>	8.5%	14.3%	2.6
3/18/13	<i>IQ v. Am. Commercial Lines</i>	15.6%	13.7%	2.3
4/30/12	<i>Gearreald v. Just Care</i>	(-14.4%)	11.7%	2.6

* The statutory interest is the Federal Funds rate plus 5%, compounded quarterly. To normalize the results despite variation in the benchmark rate, these calculations exclude the benchmark rate and are based on an interest rate of 5%. If the full interest amount paid were included, the premiums calculated here would be higher (although, in most cases, not significantly higher because the Federal Funds rate during most of the applicable periods was close to zero).

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