Appraisal Arbitrage – Delaware's Response

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Introduction

Appraisal litigation involving public companies is "undergoing explosive growth in Delaware."[1] This growth is being driven by sophisticated repeat petitioners who specialize in bringing appraisal claims – so called "appraisal arbitrageurs."[2] The growing incidence of appraisal arbitrage has garnered significant attention and commentary, and led the Council of the Corporation Law Section of the Delaware State Bar Association (the Council) to propose the amendments to Section 262 of the General Corporation Law of the State of Delaware (the DGCL) discussed below.

Delaware's Appraisal Statute

Section 262 of the DGCL provides stockholders[3] with appraisal rights in certain transactions, principally cash-out mergers.[4] The availability of and exercise of appraisal rights in modernity is theorized to serve "as a check against opportunism by a majority shareholder in mergers and other transactions in which the majority forces minority shareholders out of the business and requires them to accept cash for their shares."[5]

"More recently, [however,] a market has arisen between the stockholders subject to a merger – protection of whom was the traditional concern of the appraisal statute – and those who purchase stock from them pending the merger, seeking to maximize value through appraisal litigation."[6] That is, appraisal arbitrageurs are pursuing the investment strategy of acquiring "an equity position in a cash-out merger target with the specific intention of exercising [appraisal rights]; in the subsequent appraisal action the court awards the appraisal petitioners what the court determines to be the fair value of the target, which, if the target was undervalued in the transaction, represents a positive return on the arbitrage investor's initial investment."[7]

Recent Delaware Cases

Two recent decisions by the Court of Chancery of the State of Delaware (the Court of Chancery) – *In re Appraisal of Ancestry.com, Inc. (Ancestry)*[8] and *Merion Capital LP v. BMC Software, Inc. (BMC)*[9] – confirm that appraisal arbitrageurs' practice of seeking appraisal of shares purchased after the record date, but before the vote on the merger, is permissible under Section 262 of the DGCL.

The Court of Chancery in *Ancestry* and *BMC*, following the Court of Chancery's earlier holding in *In re Appraisal of Transkaryotic Therapies, Inc. (Transkaryotic)*,[10] rejected the contention that a petitioner who purchases shares after the record date must prove that each share it seeks to have appraised was not voted by any previous owner in favor of the merger.[11] In both cases, the respondent corporation argued that such a holding created the risk of "over-appraisal" ("the number of shares for which appraisal is sought exceeding the number not voted for the merger")[12] warranting a "share-tracing" requirement (requiring the shares subject to appraisal not to have been voted for the merger).[13] This argument was rejected by the Court of Chancery as a "theoretical" problem not present in the record.[14]

Observers "troubled" by the "explosive" growth of appraisal litigation posit that *Ancestry* and *BMC* imprudently provide renewed support for appraisal arbitrage.[15] The Court of Chancery in *Ancestry* and *BMC* recognized that each case implicated the recent policy debate surrounding the "unwholesomeness"

of appraisal litigation,[16] but affirmatively declined to consider such policy concerns on the grounds that the language of Section 262 of the DGCL was plain and unambiguous, and the Delaware legislature was the proper forum to consider and address such concerns.[17]

Also bearing on the appraisal litigation debate are the Court of Chancery's decisions in *Huff Fund Investment Partnership v. CKx, Inc. ("CKx")*[18] – both of which recently were affirmed by the Delaware Supreme Court – holding that (a) the merger price was the best indicator of the fair value of the appraised shares where the corporation was sold after a full market check, and where discounted cash flow analyses, comparable companies analyses, and comparable transaction analyses were either unavailable or unreliable,[19] and (b) the Court of Chancery lacked discretion to force the petitioner to accept payment of what the respondent corporation "consider[ed] the undisputed portion of the value of its stock" and thereby effectively toll the accrual of statutory interest under Section 262(h) of the DGCL.[20]

The Delaware Supreme Court's affirmance of the Court of Chancery's fair value decision in *CKx* may have important precedential value for the future of appraisal litigation, as it may mark the beginning of a judicial trend placing increasingly greater reliance on the merger price as the most reliable indicator of fair value, at least where there has been a robust market check.[21] Such a trend – should it occur – will undoubtedly increase the risk associated with the investment strategy of appraisal arbitrageurs.

On the other hand, the Delaware Supreme Court's affirmance of the Court of Chancery's tolling decision in *CKx* leaves the door open for "interest rate arbitrage," given the alleged "near risk-free return five percent above the Federal Discount rate," at least "where market rates of return are low…."[22] As discussed below, however, the Delaware legislature appears poised to amend Section 262(h) of the DGCL to permit respondent corporations to close the door on interest rate arbitrage.

Proposed Amendments to the Appraisal Statute

On March 6, 2015, the Council released its proposed amendments to Section 262 of the DGCL. Most significantly, the proposed amendments do not limit the exercise of appraisal rights to shares held prior to the public announcement of a proposed transaction, nor do they impose a "share-tracing" requirement, and therefore the proposed amendments do not eliminate or limit appraisal arbitrage.[23] The Council determined not to limit or eliminate appraisal arbitrage on the grounds that appraisal arbitrage does not upset the "proper balance between the ability of corporations to engage in desirable value enhancing transactions and the ability of dissenting stockholders to receive fair value for their holdings."[24]

In determining not to modify Section 262 of the DGCL to eliminate or limit appraisal arbitrage, the Council cited the following considerations, among others: (i) "Studies of appraisal arbitrage do not suggest that it encourages frivolous litigation…only 17% of the appraisal eligible transactions during 2013 resulted in appraisal litigation in Delaware"; (ii) "[A]ppraisal-out conditions [in merger agreements] remain fairly rare," suggesting "that the availability of appraisal arbitrage is not a significant factor in the market"; (iii) "Where transactions cannot be subject to a market check for structuring reasons (such as buy outs by controlling stockholders who are unwilling to sell), fiduciary duties and litigation may not be sufficient to ensure that the merger price reflects the fair value of the acquired shares"; (iv) "Recent case law[25] has suggested that a market test of a transaction will serve as a proxy for fair value in appraisal suits, so that arm's-length deals with adequate market checks do no create appraisal risks for buyers"; and (v) Delaware law has long "recognized the right of a stockholder…to pursue appraisal of shares purchased after the terms of the merger were announced."[26]

Rather than eliminate or limit appraisal arbitrage, the modifications to Section 262 proposed by the Council are intended to "improve [the] operation" of Section 262.[27] The first modification forecloses the appraisal of shares traded on a national securities exchange prior to the merger "unless the dispute with regard to valuation is substantial and involves little risk that the petition for appraisal will be used to achieve a settlement because of the nuisance of discovery and other burdens of litigation."[28] To achieve this goal, the proposed amendment to Section 262(g) of the DGCL requires (i) the appraisal proceeding with respect to shares traded on a national securities exchange prior to the merger to involve shares in excess of 1 percent of the outstanding shares entitled to appraisal, (ii) the value of such shares (based on the consideration paid in the merger) to exceed $1,000,000, or (iii) the merger to have been approved pursuant to Sections 253 and 267 of the DGCL (governing "short-form" mergers).

The second modification provides respondent corporations with the option of cutting-off the accrual of interest by paying to all petitioners, at any time before the entry of judgment in an appraisal proceeding, an amount in cash, such that from and after such payment interest would only accrue upon the difference, if any, between the amount so paid and the fair value of the shares as determined by the Court of Chancery. The Council reasons that this modification will "dampen" "the incentive for interest rate arbitrage without compromising the interests of pre-existing equity holders" and ensure that "appraisal actions will be motivated by a genuine dispute in proving that the transaction price was unfair."[29]

The Council's proposed amendments have done little to put the appraisal litigation debate to rest. To the contrary, the proposed amendments have fueled further debate.[30]

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[1] Minor Myers & Charles R. Korsmo, *Appraisal Arbitrage and the Future of Public Company M&A* (April 14, 2014), 92 Wash. U. L. Rev. ___, at 1 (forthcoming 2015), available here (hereinafter, "*Myers & Korsmo*") ("Appraisal activity involving public companies is undergoing explosive growth in Delaware, driven by sophisticated parties who specialize in bringing appraisal claims. The value of claims in appraisal in 2013 was nearly $1.5 billion, a tenfold increase from 2004 and nearly 1 percent of the equity value of all merger activity in 2013.")

[2] Id. An appraisal arbitrageur "buys stock following merger announcements for the purpose of seeking an appraisal as one of its investment strategies, a practice sometimes known as appraisal arbitrage." *In re Appraisal of Ancestry.com, Inc.*, 2015 WL 66825, at *1 (Del. Ch. Jan. 5, 2015).

[3] Section 262(a) of the DGCL sets forth the standing requirements for the exercise of appraisal rights and provides in relevant part that:

> Any stockholder of a corporation of this State who holds shares of stock on the date of the making of a demand pursuant to subsection (d) of this section with respect to such shares, who continuously holds such shares through the effective date of the merger or consolidation, who has otherwise complied with subsection (d) of this section and who has neither voted in favor of the merger or consolidation nor consented thereto in writing pursuant to § 228 of this title shall be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder's shares of stock under the circumstances described in subsections (b) and (c) of this section. As used in this section, the word "stockholder" means a holder of record of stock in a stock corporation….

8 Del. C. § 262(a).

[4] *8 Del. C. § 262.*

[5] In re *Appraisal of Ancestry.com, Inc.*, at *4 (quoting Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 Geo. L.J. 1, 4 (1995)). *See also In re: Appraisal of Transkaryotic Therapies, Inc.*, 2007 WL 1378345, at *3 (Del. Ch. May 2, 2007) ("Thus, the primary purpose of § 262 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.") (citations omitted).

[6] *In re Appraisal of Ancestry.com, Inc.*, at *4.
[7] *Merion Capital LP v. BMC Software, Inc.,* 2015 WL 67586, at *1 (Del. Ch. Jan. 5, 2015).
[8] 2015 WL 66825 (Del. Ch. Jan. 5, 2015).
[9] 2015 WL 66825 (Del. Ch. Jan. 5, 2015).
[10] 2007 WL 1378345, at *3 (Del. Ch. May 2, 2007) ("Must a beneficial shareholder, who purchased shares after the record date but before the merger vote, prove, by documentation, that each newly acquired share (i.e., after the record date) is a share not voted in favor of the merger by the *previous* beneficial shareholder? The answer seems simple. No.") (emphasis original).
[11] *Ancestry*, at *9 ("Nothing in [Section 262(e) of the DGCL] suggests that the [Delaware] General Assembly intended to require beneficial owners who made post-record date purchases to show that their specific shares were not voted in favor of the merger…."); *BMC*, at *4 ("Notably absent from t[he] language [of Section 262(a) of the DGCL], or any language in the statute, is an explicit requirement that the stockholder seeking appraisal prove that the *specific shares* it seeks to have appraised were not voted in favor of the merger.") (emphasis original).
[12] *Ancestry*, at *7; *BMC*, at *7.
[13] *Ancestry*, at *8; *BMC*, at *7.
[14] *Ancestry*, at *8; *BMC*, at *7.
[15] *See e.g.*, Theodore N. Mirvis, Trevor S. Norwitz, Andrew J. Nussbaum, William Savitt and Ryan A. McLeod, *Delaware Court Decisions on Appraisal Rights Highlight Need for Reform*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Jan. 21, 2015). ("Two recent decisions of the Delaware Court of Chancery highlight the troubling expansion of stockholder appraisal rights…the Court of Chancery permitted claims to be pursued by a petitioner who purchased its shares after public announcement of the merger for the purpose of bringing an appraisal lawsuit…."); William E. Curbow, *Recent Delaware Rulings Support Practice of "Appraisal Arbitrage,"* Harvard Law School Forum on Corporate Governance and Financial Regulation (Jan. 29, 2015), available at ("The decisions [in *Ancestry* and *BMC*] support the practice known as 'appraisal arbitrage' – a practice which has contributed to the more than tripling of incidents of appraisal petition filings in eligible deals over the past 10 years….").
[16] *Ancestry*, at *4 ("A rigorous debate exists as to whether [appraisal] litigation is wholesome…."); *BMC*, at *7 ("It is possible that appraisal arbitrage itself leads to unwholesome litigation.").
[17] *See Ancestry* at *8; *BMC*, at *7.
[18] 2013 WL 5878807 (Del. Ch. Nov. 1, 2013) and 2014 WL 454958 (Del. Ch. Feb. 12, 2014), *aff'd*, 2015 WL 631586, ____ A.3d ___ (Del. Feb. 12, 2015).
[19] 2013 WL 5878807, at *13 ("Having concluded that our law recognizes merger price as an acceptable factor that I may consider in conducting my appraisal of CKx, I also find that the evidence demonstrates in this case, where no comparable companies, comparable transactions, or reliable cash flow projections exist, that the merger price is the most reliable indicator of value. The record and the trial testimony support a conclusion that the process by which CKx was marketed to potential buyers was thorough, effective, and free from any spectre of self-interest or disloyalty…. Nor is this a case where the only evidence that a merger price was the result of 'market' forces was a post-signing go-shop period (which failed to produce competing bids) relied on to demonstrate that the transaction represented market price, and thus fair value.") (citations omitted).
[20] 2014 WL 545958, at *1 (Del. Ch. Feb. 12, 2014). Section 262(h) of the DGCL provides for an award of interest on a fair value judgment in an appraisal action of the Federal Discount rate plus 5 percent. 8 Del. C. § 262(h). Commentators have suggested that this statutory rate is overly "generous" and therefore creates "perverse incentives" encouraging "interest rate arbitrage." Trevor S. Norwitz, *Delaware Legislation Should Act to Curb Appraisal Arbitrage Abuses* (Feb. 10, 2015).
[21] *See CKx*, 2013 WL 5878807, at *11 ("This Court has previously recognized that 'an arms-length merger price resulting from an effective market check is entitled to great weight in an appraisal.'") (citing *Global GT LP v. Golden Telecom, Inc.*, 993 A.2d 497, 507 (Del. Ch. 2010), *aff'd*, 11 A.3d 214 (Del. 2010)). See also *Merlin Partners LP v. AutoInfo, Inc.*, 2015 WL 2069417 (Del. Ch. Apr. 30, 2015)

(putting "full weight" on the merger price resulting from a robust auction process). Such a judicial trend may appease commentators who have suggested that appraisal should be "reformed" "to allow acquirers a safe harbor from appraisal claims where they can demonstrate that the merger price was subject to a genuine market test." *Myers & Korsmo*, at 51. Of course, as such commentators recognize, "[t]he difficulty is in defining [the appropriate] safe harbor." *Id.* at 52. *See CKx*, 2013 WL 5878807, at *14 ("I disagree with the conclusions reached by [petitioners' expert witness, an economist]. Nothing in our jurisprudence suggests that an auction process need conform to any theoretical standard, whether a pure English auction, a second-price sealed bid, or a Vickrey auction, or any other auction format.") (emphasis original).

[22] *CKx*, 2014 WL 545958, at *2 (citing to the respondent corporation's argument in support of the tolling of interest). It appears that there is no consensus regarding whether the statutory interest rate has a negligible or significant effect on a sophisticated petitioners' decision to bring and maintain an appraisal action. Compare *Myers & Korsmo* ("[The] statutory interest rate available to appraisal petitioners (the federal funds rate plus 5 percent) is unlikely to have been the catalyst for the appraisal boom. Given the risks an appraisal petitioner must assume – an extended period of illiquidity with an unsecured claim against a surviving company that may be highly leveraged, plus the risk of the legal claim itself – the idea that interest rates are driving sophisticated parties to target appraisal is implausible."); Steven Davidoff Solomon, *Delaware Courts Pause on the Deal Price Do-Over*, The New York Times (Feb. 19, 2015),.("at the end of the day, a 5.75 percent return is not going to cut it for a hedge fund, even in a zero-interest rate environment") with Alison Frankel, *Delaware Supreme Court Upholds Market Price as Proxy for Value in Appraisals*, Reuters (Feb. 12, 2015), t ("If shareholders know judges will default to using market price as an indicator of fair value, their only risk in bringing an appraisal case is time and litigation costs. The upside, meanwhile, is that 5.75 percent interest – and the possibility that they will reap a bonanza if the judge agrees with their higher valuation. That's a bet that a lot of appraisal arbitrageurs will take."); Wilson Sonsini Goodrich & Rosati, *The Growth of Appraisal Litigation in Delaware* (Nov. 2013) ("The statutory interest rate under Delaware law creates substantial risk to the target corporation (while also incentivizing a stockholder to bring an appraisal claim by potentially limiting the investor's 'downside' risk) since even if the stockholder's recovery is limited to a value similar to the price paid in the merger, the investor currently receives compounded interest at a rate significantly above the market rates on whatever award is ultimately obtained.").

[23] It remains to be seen whether the Delaware legislature will – in considering the amendments proposed by the Council – be sensitive to the opinions of commentators, and even some companies, who have expressed the opinion that the Council's proposed amendments to Section 262 of the DGCL do not go far enough to limit appraisal arbitrage. See e.g., Trevor S. Norwitz, *Delaware Poised to Embrace Appraisal Arbitrage*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Mar. 9, 2015), ("If the lawmakers follow the recommendations of the Council (which they usually do) the changes will likely disappoint Delaware corporations, make mergers and acquisitions in that important state more difficult, reduce deal flow, and lead to lower prices being paid to selling shareholders."); Steven Davidoff Solomon, *A Three-Pronged Front to Limit Shareholder Litigation*, The New York Times (April 2, 2015), ("Instead of rushing to correct perceived flaws, it might benefit everyone to take a step back, let this unfold a bit more in the courts and then take a broader look at the entirety of Delaware law and how these provisions interact with it."); Jonathan Starkey, *Dole Pressures Delaware on Corporate Law Changes*, The News Journal (March 12, 2015) ("Dole Food Co., the fruit producer and the Port of Wilmington's largest tenant, has urged lawmakers to limit shareholder lawsuits…'Dole, like other companies incorporated in Delaware, has been spending millions of dollars in defense costs due to appraisal litigation initiated by hedge funds'"); Brandon Lowrey, *Corporate Firms Take Aim At Delaware's Appraisal Laws*, (April 7, 2015), ("Seven major corporate law firms are jointly calling for tighter controls on appraisal arbitrage…in an April 1 letter to the Council.... The letter urges legislative action to deny appraisal rights to those who purchase shares after the public announcement of a transaction, or at least restricting those who purchased their shares after the record date for the vote to seek appraisal as dissenters."). To the extent that the amendments to Section 262 of the DGCL are enacted as proposed by the Council, we may witness an increased utilization of "self-help" mechanisms such as appraisal-out conditions.

[24] Explanatory Paper titled "Section 262 Appraisal Amendments" prepared by Council, at 1-2 (Mar. 6, 2015) (hereinafter, the "Council Paper").
[25] *See e.g., CKx*, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013), *aff'd*, 2015 WL 631586, ____ A.3d ___ (Del. Feb. 12, 2015).
[26] Council Paper at 2-3.
[27] *Id.* at 3.
[28] Synopsis § 2, Proposed Amendment to Section 262(g) of the DGCL.
[29] Council Paper at 6.
[30] *See supra* note 23.