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Appraisal Rights and Shareholder Fights

Appraisal rights actions continue to be measures by which shareholder activists seek to generate value from public mergers and acquisitions (M&A) transactions. During the past few years, those actions have become more commonplace. They've served not only as a way for shareholders to increase deal value but also as a way to generate additional returns through potential arbitrage-like opportunities.

Earlier this year, the Delaware State Bar Association proposed amendments to its appraisal statute that could lead to a slowdown in actions. The proposals are a response to an increasing number of appraisal filings and are intended to minimize unsubstantiated claims and reduce the monetary benefits afforded by such actions.[1] Under the proposal, shareholders seeking to bring an appraisal action would be required to hold "at least one percent of the total shares entitled to appraisal or $1-million worth of the shares measured in deal value."[2] The legislation would also discourage petitions by eliminating interest accrual and the potential arbitrage-like opportunities interest accrual creates.

The Activist Threat

Appraisal rights protect shareholders from deals that could be perceived as being underpriced. In 2014, a record 40 appraisal rights action cases were brought against companies. Last year, another 28 were filed as of June 2015, representing shares with a face value of approximately $1.8 billion.

The appraisal process enables shareholders who are dissatisfied with the consideration offered by the acquirer to petition a court for an appraisal of their shares' fair value. In turn, the court may require a company to pay shareholders the fair value of their stock as determined in an appraisal proceeding. Under the current Delaware law, shareholders must deliver a timely and written appraisal demand to the corporation in order to exercise their appraisal rights.

Though shareholders have used the appraisal rights provision to object to the price offered in a merger or purchase transaction, there is another upside to pursuit of a rights action. In addition to the shares being revalued, shareholders can earn statutory interest on the appraisal award at the federal discount rate plus 5% from the time the deal is closed until the award is paid. In the post-2008, low-interest-rate environment, that more attractive interest rate has produced a wave of activist funds dedicated to pursuing appraisal rights actions. Typically, the funds have contested certain transactions based on valuation or the circumstances surrounding the sale of the company and may include situations involving:

- **Flaws in the sales process.** The company negotiated with a single bidder and did not consider other offers or allegedly failed to give prospective buyers the same access to due diligence.
- **An increase in stock price.** Between the deal's announcement date and close date, prices of publicly traded peers rose dramatically.
- **Higher offers.** Before agreeing to the sale, the company received a potentially higher offer, but the board did not consider it.

1 https://www.rlf.com/files/12919_Council%202016%20Proposals%20in%20Bill%20Form.pdf.
2 Section 262(g) of the Delaware General Corporation Law, http://us.practicallaw.com/cs/Satellite?blobcol=urldata&blobheader=application%2Fpdf&blobkey=id&blobtable=MungoBlobs&blobwhere=1247811155218&ssbinary=true.

Recent Cases and the Dell Buyout

Several recent court decisions have found that the negotiated merger price was the proper measure of fair value when the company embarked on a competitive and arm's-length merger process. The courts have traditionally relied on valuation processes absent evidence of price negotiations or a competitive bidding process. The focus of merger price in appraisal actions was confirmed in 2015, in *Merion Capital v. BMC Software*, 2015 WL 67586 (Del. Ch. Jan. 5, 2015). Vice Chancellor Sam Glasscock's opinion found that the merger price was in fact the most reliable indicator of fair value. Other cases, such as those involving Ancestry.com and Safeway, have settled above or below fair value. During the proposed acquisition of Ancestry.com, hedge funds contended that the fair value of the shares was as high as $47. After the company challenged the appraisal, Vice Chancellor Glasscock arrived at a valuation of $31.79. However, he concluded that the transaction price of $32 best reflected the company's fair value as of the merger date.[3] In the Safeway deal, hedge funds that held an approximately 8% ownership stake in the company notified management that they would seek an appraisal. Several of the plaintiffs in the Safeway transaction dispute settled at a significant premium—$44 a share in cash, or about $127 million more than shareholders received when the deal closed—implying that the original deal may have been undervalued.[4]

One of the bigger appraisal cases involved Dell Inc., which agreed to merge more than three years ago. After the announcement of the Dell deal, shareholders objected to the purchase price of $13.75 a share. They exercised appraisal rights by filing suit in a Delaware court, arguing that the buyout price was too low, and asking the court to determine the fair value of Dell shares. A number of funds engaged themselves in appraisal arbitrage by acquiring shares of Dell stock and subsequently exercising appraisal rights. Some investors claimed there was a significant gap between the value of Dell and its market price; investors argued that in accepting the deal, Dell had been undervalued by more than $20 billion.[5] In May 2016, the Delaware Court of Chancery ruled that the fair value of Dell's common stock at the time of its buyout in 2013 had been $17.62 per share—more than 28 percent higher than the price ($13.75 a share) the company's stockholders received under the merger. Although Vice Chancellor J. Travis Laster had previously ruled on two occasions that the deal price was in fact equivalent to fair value, in this case he ruled otherwise. For several reasons, it was concluded that the final merger consideration had not been equivalent to fair value. Among them were:

- Dell's engagement of potential financial sponsors—buyers who rely on a leveraged-buyout pricing model to achieve the required internal rate of return. Such models do not assess fair value.
- A special committee appointed by the company's board to handle the sale relied on stock trading prices as a quantitative metric even though a valuation gap existed between Dell's stock price and its fair value.
- The court arrived at its $17.62 per-share fair valuation by using its own discounted cash flow analysis.

Implications for Boards and Senior Management

It's important that boards of directors and senior management at public companies be aware of the implications of appraisal rights actions. Companies could face potential litigation and be responsible for the related costs required to resolve such disputes. Boards in particular might face reputational risk if they become viewed as agreeing to the sale of a company at a significant discount. A plaintiff might allege that the directors breached their fiduciary duty owed to stockholders to obtain the highest value reasonably obtainable after deciding to sell the company.

Companies and their advisors may be able to reduce the risk of an appraisal action by conducting a reasonable sale process that seeks to obtain the best sale price possible. Even the risk of appraisal liability can pose a threat to a company. To bring an appraisal action, a stockholder need not hold the stock on the date the merger is first made public. When a court determines that a deal price represents fair value, then the premium award of a statutory interest rate of 5% over the federal discount rate offers an incentive to file suit—and get a potentially attractive return, especially if successful in obtaining a revaluation of the shares.

M&A litigation risk poses a legitimate concern for many companies, whether it stems from increased scrutiny of the deal process or a board's ability—or inability—to fulfill its fiduciary duty by securing a fair deal price. As a result, it's important to obtain an independent, unbiased valuation from an experienced valuation expert.

3 Matt Chiappardi, "Chancery Finds Ancestry.com Stock Price Fair In $1.6B Deal," Law360.com, January 30, 2015, http://www.law360.com/articles/616985/chancery-finds-ancestry-com-stock-price-fair-in-1-6b-deal.

4 Liz Hoffman, "Safeway to Pay Hedge Funds $44 a Share to Settle Buyout Suits," *Wall Street Journal*, June 2, 2015, http://www.wsj.com/articles/safeway-to-pay-hedge-funds-44-50-a-share-to-settle-buyout-suits-1433264681.

5 Peter Hall, "Dell Takes Aim At Muddled Vote In Shareholder Appraisal Fight," Law360.com, August 7, 2015, http://www.law360.com/articles/688864/dell-takes-aim-at-muddled-vote-in-shareholder-appraisal-fight.

Valuation Considerations

When a valuation is conducted, it's important to examine the company's current fundamentals as well as its future prospects based on a variety of company and industry-specific factors. Fair value determination can also depend on (1) the methodologies applied to calculate fair value and (2) the weights and assumptions assigned to those variables in the analyst's assessment of value. Typically, multiple valuation methods are used in the determination of the fair value of the acquired company, though the specific methods used often depend on the company's specific circumstances. Traditionally, the most commonly accepted methodology in Delaware appraisal actions has been the discounted-cash-flow approach. This approach discounts a company's expected future cash flows back to the present value equivalent by applying a discount rate that reflects the risk of achieving those expected cash flows.

In the determination of a company's fair value, it's important to consider several factors such as market value as determined by current and historical pricing of the company's own publicly traded stock and the price of the stock as paid by the acquiring company in the transaction. In addition, it's important to consider a company's assets, earnings potential, future prospects, future cash flows, and the magnitude and probability of dividend payments. Last, the value of any intellectual property such as patents, trademarks, trade secrets, or other proprietary information should be considered in a determination of fair value.

Looking Ahead

Appraisal litigation remains the subject of much debate in legal circles. Although proposed legislation before the Delaware Chancery Court is designed to reduce appraisal actions by limiting arbitrage opportunities and eliminating unsubstantiated claims, the legislation could have the opposite effect. Under the new proposal, acquisition targets would be allowed to prepay some or all of the merger consideration to avoid the accrual of interest on prepaid amounts. Some experts have speculated that the number of actions may continue to rise because activist funds receive payment sooner and have additional capital on hand to bring such actions.

Given what's at stake, it will be interesting to see whether companies develop their own tactics to combat the threat of appraisal rights actions. The threat of an action and potential litigation can be worrisome for a company, its legal counsel, and its shareholders. They may face protracted litigation, which not only has a heavy financial cost but also often creates significant distraction from the company's day-to-day operating of the business. As a result, it's important that companies, their boards, and their senior managements take the right steps when considering an M&A transaction, and if entering into one, seek to reduce potential risk by taking reasonable approaches to both valuation and the sale process.

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