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Dissenters Pose Bigger Risks to Corporate Deals

The appraisal rights of shareholders that object to mergers and acquisitions are gaining strength.

BY WILLIAM SAVITT

In most mergers and acquisitions, stockholders who are cashed out of their shares have the option of dissenting from the deal and seeking the "fair value" of their shares instead of the proposed merger consideration. Such dissenter's rights have traditionally been a minor consideration for dealmakers, since typically only a small fraction of stockholders have opted to pursue appraisal, and appraisal rights seldom affected the overall economics of a merger.

Several recent developments, however, have created new and more substantial appraisal-related risks for acquiring companies.

To appraise their shares, stockholders must either vote against the proposed merger or not vote at all, and then comply with a number of procedural formalities. If the merger ultimately closes, dissenters cannot accept the merger consideration, but they earn the right to bring a lawsuit in which they can establish and receive the "fair value" for their shares.

Even if the merger has been heavily negotiated at arms' length, the courts are not required to give deference to the merger price in determining fair value. Instead, Delaware law provides that the appraisal court can consider "any valuation methodology" and use "any techniques" to decide what price is fair for a dissenter's shares.

Appraisal trials typically turn on the dueling testimony of financial experts regarding inherently uncertain estimates of future economic developments, which makes it difficult to predict the outcome with confidence.

Although the appraisal price, in theory, can be either higher or lower than the merger price, appraisal judgments overwhelmingly have tended to exceed the deal price. According to one estimate, some 80 percent of appraisal proceedings resulted in "fair value" awards exceeding the price paid to the stockholders who accepted the merger consideration.

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EMERGING TREND

Three recent developments have conspired to raise the risk profile of potential appraisal claims to acquirers. The first is the 2007 *Transkaryotic* decision of the Delaware Court of Chancery. Before *Transkaryotic*, it was generally thought that only stockholders who held shares as of the record date for a meeting to vote on a merger could perfect appraisal rights. It meant that latecomers could not buy into an appraisal claim, limiting the pool of potential dissenters.

But in *Transkaryotic*, the Court of Chancery held that appraisal rights are available to anyone who holds stock up until the stockholder meeting—even if they acquire such stock after the record date. As a result, investors could wait until just before the stockholder vote to purchase a target's stock, providing them with additional time to evaluate potential appraisal claims and a decreased risk of buying into a busted deal.

This decision thus paved the way for the growth of a new business—appraisal arbitrage—in which institutional investors buy up stock just before a deal closes, and then bring large-scale appraisal claims if the conditions are right after closing. It has taken a while, but a number of appraisal-focused arbitrage hedge funds have now emerged in response to these incentives. These funds have pumped hundreds of millions of dollars into appraisal claims, and the numbers are expected to rise.

The second development spurring appraisal is the current interest-rate environment. Stockholders who seek appraisal are entitled to the fair value of their shares plus statutory interest compounded quarterly from the date the merger becomes effective to the date on which an appraisal judgment is paid. Delaware's statutory interest rate is generally the Federal Reserve discount rate plus 5 percent—far higher than any rate available in the market. Investing in appraisal actions thus provides an attractive rate of return.

The high interest rates offset the cost of litigating the appraisal action and create the potential for a substantial bonus on top of the fair-value award.

Still another development is the potential willingness of the Delaware courts to entertain a cause of action called "quasi-appraisal," which, as has been discussed in recent judicial commentary, would permit the stockholders of a target to seek appraisal in the event that proxy materials are found, post-vote, to have contained material errors or omissions. If validated, quasi-appraisal would allow all stockholders to pursue appraisal, on a class basis, even if they did not vote against the merger and even after they have accepted the merger consideration.

Quasi-appraisal has been applied only in unusual circumstances and may not be approved as a regular feature of Delaware law. Nevertheless, the specter of a classwide appraisal claim is attractive to potential plaintiffs and a further potential risk for buyers.

INCREASE IN APPRAISAL ACTIVITY

Against this backdrop, appraisal claims are on the rise. Among high-profile examples, some 12 percent of the outstanding shares sought appraisal in connection with the recent Dole Food Co. Inc. transaction, and Carl Icahn threatened to seek appraisal for 8.9 percent of shares outstanding in connection with the recent Dell Inc. transaction. Public filings indicate that as much as $1 billion may be invested in other outstanding appraisal actions—all of which create the potential for the effective price of closed transactions to rise when the appraisal claims are settled or decided.

As the court noted in *Transkaryotic*, fully resolving these issues may require a legislative fix. In the meantime, dealmakers should keep an eye on the rising tide of appraisal litigation, and their lawyers should focus on ensuring the best possible record to mitigate this increasingly frequent species of postclosing exposure.

WILLIAM SAVITT *is a partner in the litigation department of Wachtell, Lipton, Rosen & Katz. His practice focuses on representing corporations and directors in litigation involving mergers and acquisitions, proxy contests, corporate governance and class actions.*