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Delaware Legislature Should Act to Curb Appraisal Arbitrage Abuses

By *Trevor S. Norwitz* February 10, 2015

A triad of recent decisions out of the Delaware Court of Chancery highlight the urgent need for legislative reform in Delaware to ameliorate the risk that appraisal arbitrage – now a multibillion dollar industry – poses to transactional vitality and shareholder value.

In two recent cases, *In re Appraisal of Ancestry.com, Inc,* [1] (Ancestry I) and *Merion Capital LP vs. BMC Software* [2], Vice Chancellor Glasscock followed the literal interpretation of the Delaware appraisal statute adopted in 2007 by Chancellor Chandler in *In re Appraisal of Transkaryotic Therapies, Inc*.[3] Before *Transkaryotic*, it was generally understood that only shareholders who owned shares on the record date for the vote on the transaction could dissent and seek judicial appraisal of their shares. In these three cases, however, the Court of Chancery has established that the Delaware statute permits appraisal arbitrageurs – short-term investors who buy shares in target companies after the record date for the vote specifically for the purpose of asserting appraisal rights – to perfect appraisal rights without having to show that the shares for which they are seeking appraisal were not voted in support of the merger. *Transkaryotic* spawned an entire new investment class, with hedge funds, plaintiffs law firms and valuation experts dedicated specifically to this new "activist" strategy. Commentators have been warning for years of the dangers of appraisal arbitrage, including increasing complexity of and risk to transactions, and diversion of value from the general body of shareholders to small groups of appraisal "raiders." In recent years, funds dedicated to this strategy have grown to the billions of dollars. The Chancery Court's interpretation of the appraisal statute could lead to the perverse result that multiples of the number of shares not voted in favor of a merger could be entitled to appraisal. In such a situation, as one commentator noted, "[t]he framework established by *Transkaryotic* makes each claim individually colorable but collectively asinine."[4] Noting that these circumstances were not present in the two recent cases, Vice Chancellor Glasscock suggested that this was a problem for the legislature rather than the judiciary to fix.

In his follow-up decision, *In re Appraisal of Ancestry.com, Inc.*[5] (Ancestry II), the Vice Chancellor determined that the fair value to be paid to the petitioners for their shares was the negotiated merger price (even though his own discounted cash flow analysis indicated a value slightly below the merger

price). While value created from the transaction itself is not to be included in the fair value determination, no significant synergy value was found in this case, a sale to a private equity fund. With this outcome, it is less likely that Ancestry I will be appealed to the Delaware Supreme Court, which has yet to weigh in on the validity of appraisal arbitrage.

Ancestry II confirms that the price resulting from a comprehensive arm's-length sales process will be accorded substantial weight in Delaware appraisal proceedings. In this sense it was a welcome development, coming after several years in which most appraisal cases led to higher payments (sometimes much higher, although many of these were in conflict situations) and the Delaware Supreme Court's explicit rejection of a rule requiring the Court of Chancery to defer to the merger price, even presumptively, in appraisal proceedings.[6] However, while this restraint may partially mitigate the risk of an appraisal arbitrage avalanche, it is by no means a panacea. Indeed, the decision also gives comfort to the appraisal arbitrageurs that their likely worst case scenario (at least in a deal without significant synergies) is that they will receive the deal value plus the very generous Delaware statutory interest rate. Absent a legislative correction, the *Transkaryotic* framework is likely to lead to continued and increased appraisal arbitrage. By way of example, hedge funds holding around 8% of Safeway recently announced their intention to seek appraisal of the price they are to receive in its $9 billion buyout by Albertsons.

Appraisal arbitrage creates significant risks for buyers, who could find themselves obligated to pay much more for a target company than they had expected to when negotiating the deal. While any buyer needs to know how much it will have to pay to acquire a target, this need is especially acute in leveraged acquisitions where an increase in acquisition costs could easily make the difference between a successful deal and a failure, or even a bankruptcy.

This uncertainty is exacerbated by the fact that the relevant appraisal valuation date is the closing of a transaction, rather than the time of announcement of the deal or the shareholder vote. This gives the appraisal arbitrageur a free option on positive developments between signing and closing. Indeed in the Safeway case, appraisal seekers are expected to argue that they should be entitled to higher consideration because grocery stocks rose between the signing and closing of that deal, in part due to the decline in oil prices. Moreover, this option continues for 60 days post-closing by law, and much longer in practice, as buyers will generally be more than happy to pay the deal price to make an appraisal case go away. It is unlikely that in adopting the appraisal rights regime the Delaware legislature intended to create such a "heads-I-win-tails-I-don't-lose" option for arbitrageurs.

This construct would, for example, make it very challenging to sell a biotech company while approval of a promising drug is pending if the company's value is significantly affected by the outcome of that approval. Such a company might be worth $2 billion if the FDA approves its drug and nothing if it is rejected, and the board may want to sell the company for $1 billion to a large pharmaceutical acquirer rather than take the risk. However such a transaction may not be possible if appraisal arbitrageurs can lie in wait until closing to capture the value if the approval comes through or accept the deal price if it does not. The Delaware legislature (and the drafters of the Model Business Corporation Act) should seriously consider whether the appropriate time for determining fair value for appraisal purposes is the time of announcement or perhaps rather the vote on the transaction, instead of the potentially much later time of consummation. However, even without that more dramatic change in law, this problem can be substantially ameliorated if the appraisal arbitrage phenomenon spawned by *Transkaryotic* is arrested by requiring those who would assert appraisal rights to demonstrate that their shares were not voted in favor

of the deal. A strong case can be made for an even broader, if simpler, rule prohibiting anyone who acquires shares after the record date (arguably even after announcement of the transaction) from asserting appraisal rights, but it is not necessary to go that far to solve the problem. Appraisal arbitrage has nothing to do with the purpose for which the remedy was created. Appraisal rights – otherwise known as dissenters rights – were designed to provide a safety valve for shareholders of an acquired company who are dissatisfied with the consideration they are to receive, by allowing them to seek a judicial determination of the "fair value" of their shares. The remedy was not designed to create a new way for short-term speculators to game the system and profit at the expense of the broader shareholder body.

The appraisal arbitrage problem is further exacerbated by the generous statutory interest rate in Delaware for appraisal proceeds – prime plus 5% compounded – which means that even an entirely meritless appraisal claim will often still be an extremely attractive investment. With such a safety net, arbitrageurs are incentivized to assert appraisal and see what happens: some positive development may allow them to argue that the value of the target has increased before the closing, or, as is often the case, they may convince the purchaser to pay them off (that is, offer them extra consideration not being shared with the rest of the shareholders) to buy certainty. Their likely worst case scenario is the deal price plus an above-market compound interest rate, which – especially if they use leverage – still provides an attractive return. To eliminate these perverse incentives, the statutory interest rate should be lowered to a market rate. Strong arguments can also be made for allowing the buyer to "defease" any appraisal liability by depositing the merger consideration into a separate escrow-type account (without prejudice to its ability to contest fair value).

Of course, when they recognize these risks – as they now must with billions of dollars devoted to appraisal as an investment strategy – buyers will seek to pass them on to target companies and their shareholders. One way to do this would be for a buyer to insert an appraisal rights closing condition of the type that used to be fairly prevalent a few years ago, allowing it to walk from the deal if more than a specified percentage, say 5%, of target shareholders assert appraisal rights before closing. This would of course be a most undesirable development for the seller and its shareholders, as it adds a large and uncontrollable risk to the transaction. It is also not an ideal solution for the buyer, because it would be strongly resisted, still leaves uncertainty as to the ultimate purchase price (although the risk is at least cabined), creates its own opportunities for arbitrageurs to challenge the transaction, and gives the buyer a walk-away right it may not want to exercize, if for example the deal has strategic importance. An alternative formulation might involve a differential purchase price: $X if more than 5% of shareholders assert appraisal; $X+Y if not. Although this would be unusual for a public company merger, artful challenges call for creative solutions. Most likely, however, buyers will just respond to the new wave of appraisal arbitrage with lower purchase prices, as they feel the need to hold something back for the likely appraisal "grab," much as they already do when the risk of an activist hold-up is high. Clearly none of this what the Delaware legislature intended when they created the dissenters rights remedy.

Vice Chancellor Glasscock noted that if the legislative intent behind appraisal rights is not being met by the current wording of the statute, then it is for the Delaware legislature to fix. The Delaware General Assembly should correct the appraisal rights regime as a matter of urgency. At a minimum, only shares that were (demonstrably) not voted for a merger should be entitled to appraisal, and the statutory interest rate should be reduced.

ENDNOTES

[1] C.A. No. 8173-VCG (Del. Ch. Jan. 5, 2015)

[2] C.A. No. 8900-VCG (Del. Ch. Jan. 5, 2015)

[3] C.A. No. 1554-CC (Del. Ch. May 2, 2007)

[4] George S. Geis, An Appraisal Puzzle, Northwestern University Law Review, Volume 105, No. 4 (2011).

[5] C.A. No. 8173-VCG (Del. Ch. Jan. 30, 2015)

[6] Golden Telecom, Inc. v. Global GT LP, No. 392, 2010, C.A. No. 3698 (Del. Dec. 29, 2010) (Steele, C.J.)

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