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Delaware Poised to Embrace Appraisal Arbitrage

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Delaware corporations and their advisers have been eagerly awaiting the response of the Delaware legislature to the recent surge in appraisal arbitrage and judicial pronouncements allowing this activity and suggesting that lawmakers should step in if they perceive a problem. It now appears based on a proposal released by the Delaware Corporation Law Council that the legislature may act as soon as this week. 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. The beneficiaries of this legislation will be the small (but growing) group of short term speculators specializing in appraisal arbitrage and the advisors who support that industry. Some of the problems created by appraisal arbitrage are described in my post on this subject a few weeks ago.

The Council does propose to provide some relief by allowing a corporation facing an appraisal claim to cut off the accrual of statutory interest as to the amount it pays to all claimants. This should help reduce the perverse incentives that have afflicted Delaware companies for years, whereby even meritless appraisal claims often turn out to be good investments because of the above market compound statutory interest rate. It is unfortunate that the Council is not also proposing to lower this above-market interest rate. If a company facing an appraisal claim were, for example, to pay 75% of the deal price to the claimants while continuing to argue that the 75% is the fair value to which they are entitled, the company would only be liable to pay interest on any amount above that 75% that the claimant is awarded. Such partial payments may change the calculus for appraisal arbitrageurs, and hopefully discourage unmeritorious claims, although they would also provide cash to fund appraisal litigation. The Council also recommends allowing corporations to dismiss *de minimis* claims (involving less than $1 million and less than 1% of the

outstanding shares) with limited exceptions. Those small claims were never a serious threat to buyers or deal making, but the change should enhance judicial efficiency.

The disappointing aspect of the Council's proposal is that they have determined not to take this opportunity to limit appraisal arbitrage by requiring that appraisal seekers demonstrate that the shares they are asking the courts to appraise were not voted in favor of the transaction. In a note accompanying their proposal, the Council offers several reasons for their affirmative embrace of appraisal arbitrage, but these explanations do not appear to appreciate the deal-threatening and value destructive nature of this activist tactic or to justify the failure to act.

The Council states that "to the extent that the appraisal remedy is necessary to protect stockholders, its effectiveness would be curtailed if the statute were amended to limit the ability to transfer the right" and notes that Delaware case law has for years recognized the right of a stockholder who has otherwise perfected his appraisal rights to pursue appraisal of shares purchased after the terms of the merger were announced. But this is a straw man. The proposed solution is not that shares entitled to appraisal should not be transferable with that right. The point is that *only* shares that were not voted in favor of the transaction should be entitled to appraisal, because appraisal is a *dissenters' remedy*. Appraisal should not be available for shares that were voted in favor. If an arbitrageur buys shares, for example in a private transactions, and can show that they were not voted in favor of the deal, appraisal rights would always have been available. (That said, one can certainly argue that the simplest and purest solution to the problems created by appraisal arbitrage would be to disallow appraisal claims by anyone who bought shares after public announcement of the transaction.)

The real question is whether the appraisal remedy is actually "necessary to protect stockholders," and here the Council can only point to conflict transactions as cases where "fiduciary duties and litigation may not be sufficient to ensure that the merger price reflects the fair value of the acquired shares." Such transactions, they argue "have a greater potential for unfairness and frequently result in appraisal awards at a premium to the merger price, sometimes a very significant premium." If that is the case, why not limit appraisal arbitrage to those sorts of suspect transactions? Moreover, why should fiduciary duty litigation not be the appropriate remedy for those cases? The fact that it is easier for the plaintiffs lawyers to win, because they do not have to prove any wrongdoing by the board but simply show higher value (often with the benefit of hindsight or even changed circumstances), is not an adequate explanation. An obvious advantage of fiduciary duty litigation is that all shareholders in the class share in any incremental value required to be paid by the buyer. It is likely that buyers will respond to increased appraisal arbitrage by lowering the price payable to all shareholders and holding back some incremental value to grease the squeaky wheels. It is somewhat ironic that if the board process can be shown

to have been flawed, all shareholders share the benefit, but if the board did all they could to get the best available deal, some portion of the shareholders' value should be siphoned off and diverted to short-term speculators in appraisal rights.

The Council's third line of argument for not limiting appraisal arbitrage is that it is unnecessary to do so because it is not at crisis levels ("only 17% of the appraisal eligible transactions during 2013 resulted in appraisal litigation in Delaware"—that number does not seem low to me) and the courts tend to get to the right place eventually anyway. They note that "[r]ecent case law has suggested that a market test of a transaction will serve as a proxy for fair value in appraisal suits" and that "[a]ppraisal cases attacking the merger consideration in non-conflict transactions are fewer in number and often result in appraisal results below or near the merger consideration." This is of course true (although the Delaware Supreme Court has ruled that the Court of Chancery may not defer, even presumptively, to the merger price in determining fair value[1]) but it still leaves purchasers facing an unquantifiable risk they have to take into account in offering to buy a company. Moreover, it is not a reason to protect market behavior which is otherwise destructive and almost certainly inconsistent with the original legislative purpose for granting dissenters appraisal rights. Indeed another group that is unlikely to welcome this rule-making are the Delaware judges themselves, who will continue to have to spend a significant portion of their time playing investment banker (but without commensurate compensation) as appraisal cases make up a significant and growing part of their dockets.

Finally the Council argues that the legislature does not have to address appraisal arbitrage because "[t]o the extent that the buyer in a merger has concern about an increased number of merger claimants and the overall cost of the transaction, the buyer can negotiate an appraisal out condition (e.g. a right not to close the merger if more than a specified percentage of shareholders dissent and demand appraisal)." This is of course also true, but hardly a positive development for buyers or for sellers. The fact that such appraisal-out conditions remain fairly rare does not suggest "that the availability of appraisal arbitrage is not a significant factor in the market." Appraisal out conditions disappeared because appraisal claims were vanishingly rare, and because they give rise to potential hold-ups and other value-destroying outcomes. But these conditions can be expected to reemerge if this new activist abuse is given a legislative imprimatur.

The Council's reasoning does not address the additional risk I had highlighted in my earlier piece that appraisal arbitrage may make it extremely difficult, if not impossible, to sell companies with upside contingencies (such as a biotech company awaiting FDA approval for a new drug).

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

In short, the Council's recommendation that the Delaware legislature not address appraisal arbitrage (other than to discourage interest arbitrage and eliminate *de minimis* claims) is disappointing and may significantly harm Delaware corporations and their shareholders.

It has been reported that billions of dollars are now devoted to appraisal arbitrage, and with the blessing of the courts in Delaware and soon perhaps the legislature as well, it is likely that even more transactions will be subjected to appraisal claims. As a result, corporate acquirers will have to resort to self-help if they want to know in advance how much an acquisition is going to cost them (which is always important but especially critical in leveraged transactions). This self-help may take the form of the appraisal closing conditions suggested by the Council, or differential pricing (such as an automatic price reduction if too many shareholders assert appraisal). More likely it will just mean lower acquisition prices being offered to all shareholders, as buyers now know they will have to contend with a new category of hold-up artists. Some companies with near-term contingences they would like to de-risk may find it hard to sell themselves at all. It is difficult to see how this shift of value from shareholders as a whole to a small group of short-term speculators is socially advantageous or in the best interests of State of Delaware.