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Corporate Governance Update: Shareholder Activism in the M&A Context

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With M&A activity expected to increase in 2014, shareholder activism is an important factor to be considered in the planning, negotiation, and consummation of corporate transactions. In 2013, a year of relatively low deal activity,[1] it became clear that activism in the M&A context was growing in scope and ambition. Last year activists were often successful in obtaining board seats and forcing increases in deal consideration, results that may fuel increased efforts going forward. A recent survey of M&A professionals and corporate executives found that the current environment is viewed as favorable for deal-making, with executives citing an improved economy, decreased economic uncertainty, and a backlogged appetite for transactions.[2] There is no doubt that companies pursuing deals in 2014—whether as a buyer or as a seller—will have to contend with activism on a variety of fronts, and advance preparation will be important.

While the traditional areas of board representation and deal price no doubt will remain the highest value targets in M&A activism, one newer area to watch for activity in 2014 is appraisal rights litigation and arbitrage, which became a more common tactic pursued by activists in 2013. Shareholder activism is poised to have an even greater impact in the M&A context this year and companies should be aware of and prepared for this possibility if they pursue an M&A transaction.

2013 Trends to Continue

In 2013, the power and influence of activist hedge funds rose to new heights. In financial terms, hedge fund assets under management ended the year at a new record: capital invested in the global hedge fund industry was reported to be $2.63 trillion, while U.S. activist hedge funds are now estimated to hold close to $100 billion in assets under management.[3]

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[1] Mergermarket reports that deal value in 2013 was $2,215.1 billion, down 3.2 percent from $2.288.8 billion in 2012. 2013 saw the lowest deal value since 2010. *See* Mergermarket M&A Trend Report: 2013 (Jan. 3, 2014) available at www.mergermarket.com/pdf/Mergermarket.2013.FinancialAdvisorM&ATrendReport.pdf.

[2] KPMG 2014 M&A Outlook Survey Report at 1, available at www.kpmg.com/IE/en/IssuesAndInsights/ArticlesPublications/Documents/2014-m-a-outlook-survey-report.pdf.

[3] *See* HFR Global Hedge Fund Industry Report, Jan. 21, 2014 available at www.hedgefundresearch.com/?fuse=products-irglo.

Activists have become increasingly ambitious in their selection of targets and inventive in their choice of tactics. In 2014, as in 2013, large, well-known companies should anticipate being targeted by activist campaigns, and they can expect the activists to be sophisticated not only in their demands but also in their use of media, outside experts, and litigation strategy to achieve their objectives. Moreover, so far in 2014, smaller companies have increasingly been targeted by activists, many of whom are newly formed activist funds.

In 2013, activists experienced unprecedented success in the outcomes of their campaigns in the M&A context. One source estimates that the percentage of activist attacks that were successful in either raising deal price or terminating a deal was a stunning 71 percent through November of 2013, an overwhelming increase from 25 percent in 2012 and 19 percent in 2011.[4] Moreover, activists have had significant success in adding their designees to the boards of target companies. Institutional Shareholder Services (ISS) estimates that activists won board seats in 68 percent of proxy fights in 2013 (not including cases in which board seats were gained without a fight in a settlement), versus 43 percent in 2012.[5] At the same time, activists have garnered a degree of legitimacy that they have never before enjoyed. Traditional investment funds now routinely work with activist hedge funds, and even many independent directors of target companies are more receptive to activist proposals than ever before. As activist hedge funds become substantial shareholders in many companies, they become an increasingly significant factor for companies considering M&A activity in 2014.

Appraisal Rights: Background

An emerging weapon in the activist arsenal in the M&A context appears to be appraisal rights litigation, or at least the threat of such litigation. Appraisal rights are a well-known but generally insignificant footnote to cash mergers: in Delaware, shareholders who object to a cash offer for their shares have the right to dissent and seek a higher price through litigation.[6] In order to perfect appraisal rights in Delaware, shareholders must either vote against or abstain from voting on the merger; they must also refuse to accept the merger consideration paid to the other shareholders at closing. After the merger is completed, the dissenters then have the right to file suit in Delaware, asking a court to independently determine the value of their shares as of the merger closing date. The dissenters have sixty days post-closing in which to pursue appraisal or accept the price paid in the merger.

Historically, appraisal rights litigation has not been significant; in the last two decades, only forty-five appraisal cases have carried through to the issuance of a post-trial opinion. However, this type of action appears to be emerging as a more prominent feature of the M&A landscape. Overall, the value of appraisal rights cases brought in Delaware has been

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[4] *See* Alan Klein, "Shareholder Activism in M&A Transactions," Simpson Thacher & Bartlett Memorandum, Feb. 26, 2014, available at https://blogs.law.harvard.edu/corpgov/2014/02/26/shareholder-activism-in-ma-transactions.

[5] *See* Stephen Foley, "Activist hedge funds managers get board welcome," Financial Times, Dec. 23, 2013, available at www.ft.com/cms/s/0/71362352-68e0-11e3-bb3e-00144feabdc0.html#axzz2x0FxobX6.

[6] Del. Gen. Corp. L. § 262, available at delcode.delaware.gov/title8/c001/sc09/. As discussed below, appraisal rights are now available to target shareholders in exchange offers if the merger is consummated under new Section 251(h) of the Delaware corporation law. *See* text accompanying note 30.

rising: one study found that appraisal claims were brought with respect to 15 percent of takeovers in 2013 and that the value of the claims was $1.5 billion, ten times the value of such claims in 2004.[7] So far this year, twenty appraisal claims have been filed in Delaware, as compared to thirty-three in all of 2013.[8]

Various factors are contributing to the rise of appraisal rights activism, including legal developments and financial conditions as well as the general aggressiveness and ascendancy of hedge fund activists. In terms of legal developments, a series of cases regarding appraisal rights have created greater opportunities for appraisal rights arbitrage and mitigated slightly the risks inherent in judicial determination of share value. Setting the stage for action was a 2007 Delaware Chancery Court opinion that surprised observers by ruling that appraisal rights are available to holders of stock on the date of the merger vote, rather than on the much earlier record date.[9] This ruling made it possible for investors to analyze a deal and purchase shares at the final hour with the intent of pursuing appraisal.[10] As noted above, commencing appraisal proceedings then gives shareholders a sixty-day option on the merger consideration while they evaluate the potential upside of appraisal rights litigation.

While appraisal litigation is risky and can be costly, historically, it has been financially worthwhile for the plaintiffs. One review of Delaware case law found that over 80 percent of appraisal rights cases resulted in a finding of fair value by the court that was higher than the merger price paid.[11] Indeed, in many cases it was significantly higher, with one analysis finding a median premium of 82 percent over the merger price.[12] These statistics may only reflect that appraisal proceedings in the past often have been brought in egregious circumstances, but the track record nevertheless appears to be spurring an increase in appraisal demands. A further catalyst is that the Delaware appraisal statute entitles dissenters to interest, compounded quarterly from the merger closing date until the date that they receive the fair value of their shares, at a very favorable rate set by a recent amendment to the statute: the Federal Reserve discount rate plus five percent.

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[7] *See* Steven M. Davidoff, "New Form of Shareholder Activism Gains Momentum," NYTimes.com Dealbook, Mar. 5, 2014 (citing an unpublished paper by Professor Minor Myers and Professor Charles Korsmo), available at dealbook.nytimes.com/2014/03/04/a-new-form-of-shareholder-activism-gains-momentum/?_php=true&_type=blogs&_r=0.

[8] Bloomberg Law Database (search conducted Mar. 18, 2014).

[9] In re Appraisal of Transkaryotic Therapies, Inc., C.A. No. 1554-CC (Del. Ch. May 2, 2007), available at courts.delaware.gov/opinions/(wshozyqwortjg2bswbmuwzbl)/download.aspx?ID=91460.

[10] Transkaryotic at 7-8 ("Respondents raise one policy concern that deserves mentioning. They argue that this decision will 'pervert the goals of the appraisal statute by allowing it to be used as an investment tool for arbitrageurs as opposed to a statutory safety net for objecting stockholders.' That is, the result I reach here may, argue respondents, encourage appraisal litigation initiated by arbitrageurs who buy into appraisal suits by free-riding on Cede's votes on behalf of other beneficial holders—a disfavored outcome." (footnotes omitted)).

[11] *See* Jeremy Anderson & Jose P. Sierra, "Unlocking Intrinsic Value Through Appraisal Rights," Law360, Sept. 10, 2013, available at www.law360.com.

[12] *See* Lawrence M. Rolnick & Steven M. Hecht, "Del. Weighs in on Fair Value in Appraisal Rights Cases," Law360, Aug. 7, 2013, available at www.law360.com.

With respect to determining fair value itself, the court has enormous leeway, and trials generally center on expert testimony. From 2010 through 2013, Delaware courts consistently held that the price paid in the merger would not be given any presumptive weight in the determination of fair value for a dissenter's shares. Moreover, these courts reaffirmed a prior holding that the appraisal would be based on the value of the company as a going concern as of the merger date, not as of the offer date.[13] Therefore, any value added between the closing of the offer period and the consummation of the merger would increase the fair value of the shares.[14] While a court may choose its valuation methodology, some recent cases have determined fair value based on the discounted cash flow method, which is well-understood and lends itself to principled analysis from a financial risk-benefit standpoint.[15] Discounted cash flow analyses, however, often produce values in excess of what a buyer would be willing to pay or the value of the company's stock in the public trading markets. In two widely-noted 2013 cases that went to trial, the court used the discounted cash flow methodology and determined that the fair value of the shares was significantly higher than the merger price. In the merger of one Cox Enterprises, subsidiary with another, the court found, valuing the company as a going concern, that the fair value per share was $5.75, as opposed to the offer price of $4.80.[16] Similarly, in the merger of 3M Company and Cogent, the plaintiffs—including four large hedge funds—won a 3.5 percent premium over the offer price.[17] Though one case in November 2013 looked to the merger price for guidance rather than relying upon a discounted cash flow analysis, the court noted that in this particular case, the DCF methodology was essentially unavailable due to a lack of reliable projections.[18]

The highest-profile appraisal rights case of last year involved Carl Icahn's campaign against the Dell going-private transaction. In February 2013, a buyout group led by Michael Dell entered into an agreement to take the company private in a $24.4 billion transaction. Icahn, who began acquiring Dell shares after the transaction agreement was announced, joined with Southeastern Asset Management and some other large Dell shareholders to oppose the transaction on the basis that the price was too low. Icahn presented various alternative leveraged recapitalization plans over the course of several months, but both the Dell

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[13] *See, e.g.*, Golden Telecom v. Global GT LP, 11 A.3d 214 (Del. 2010) (rejecting any rule that would require the Court of Chancery to defer to the merger price in an appraisal proceeding); Merion Capital LP v. 3M Cogent Inc., C.A. No. 6247 (Del. Ch. July 8, 2013) (reiterating that the going concern value of the company is the relevant inquiry), available at courts.delaware.gov/opinions/download.aspx?ID=191670.

[14] Cede & Co. v. Technicolor, Inc., 684 A.2d 289, 298 (Del. 1996) (stating that "value added to the going concern by the 'majority acquirer,' during the transient period of a two-step merger, accrues to the benefit of all stockholders and must be included in the appraisal process on the date of the merger").

[15] *See, e.g.*, The Brattle Group, "Recent Guidance from the Delaware Court of Chancery," Summer 2013, available at www.brattle.com/system/publications/pdfs/000/004/891/original/Recent_Guidance_From_the_Delaware_Court_of_Chancery.pdf?1378903543; Edward M. McNally, "Are Appraisal Cases Coming Back?" Del. Bus. Ct. Insider, July 17, 2013, available at www.morrisjames.com/pp/article-184.pdf.

[16] Towerview LLC v. Cox Radio, Inc., C.A. No. 4809 (Del. Ch. June 28, 2013), available at www.delawarebusinesslitigation.com/uploads/file/towerview%20v%20%20cox%20radio.pdf.

[17] Merion Capital, L.P. v. 3M Cogent, Inc., *supra*.

[18] Huff Fund Investment Partnership v. CKx, Inc., C.A. No. 6844-VCG (Del. Ch. Nov. 1, 2013), available at courts.delaware.gov/opinions/download.aspx?ID=196960.

board and ISS recommended that shareholders accept the original buyout transaction instead. Meanwhile, Icahn urged his fellow shareholders to exercise their appraisal rights under Delaware law, primarily as a means to encourage shareholders not to vote for the transaction. Although the transaction received support from a majority of the total shares outstanding, and a majority of the shares not held by Michael Dell and affiliated parties that voted on the transaction, in the face of the Icahn campaign, the going-private transaction was not able to gain the much higher vote of a majority of the outstanding unaffiliated shares required by the original transaction agreement. Ultimately, the buyout group increased their offer in exchange for a change in the voting rules so that the separate vote of the unaffiliated shares would be based on shares voting rather than shares outstanding. In September 2013, the shareholders approved the transaction, and thereafter, Icahn withdrew his appraisal demand. Whether or not Icahn ever actually intended to pursue appraisal rights litigation, the credible threat of doing so appeared to be one of several factors in his push for a higher buyout price, which he (and the other shareholders) ultimately received. And although Icahn did not in the end pursue appraisal rights, a number of other former Dell shareholders did exercise appraisal rights.[19]

Appraisal Rights: Looking Ahead

Activists have shown increasing interest in the possibilities of appraisal rights lawsuits. During the Dell buyout process, the Shareholder Forum, an activist organization, launched a registered trust designed to make dissenting more attractive.[20] The idea was that dissenting Dell shareholders could trade their shares for trust units, which would be listed on an exchange and theoretically cashed out in the market at any time. The trust was designed to mitigate one major reason that appraisal rights cases historically have held limited appeal, namely, the fact that dissenting shareholders have their investment tied up for months or years while the lawsuit is adjudicated. The Shareholder Forum encourages investors to use appraisal rights claims as "practical investments," particularly when held as marketable and managed holdings in an investment vehicle similar to the one developed for Dell shareholders.[21] Whether such a market could indeed be generated is, at the moment, an open question.[22]

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[19] Bloomberg Business Week, "T. Rowe to Magnetar Demand Dell Appraisal After Buyout (Correct)," Nov. 28, 2013 ("T. Rowe Price Group Inc. and more than 100 other Dell Inc. shareholders who control a combined 47.5 million shares spurned the company's buyout offer to seek a potentially higher payout through the Delaware court system"), available at www.businessweek.com/news/2013-11-28/t-dot-rowe-to-magnetar-capital-demand-dell-appraisals-after-buyout; *see also* M&A Law Prof Blog, "Dell Appraisal," Nov. 29, 2013, available at lawprofessors.typepad.com/mergers/2013/11/dell-appraisal.html.

[20] *See* The Shareholder Forum, Dell Valuation Home Page, available at http://www.shareholderforum.com/dell/index.htm.

[21] *See* The Shareholder Forum, "Appraised Value Rights: A Summary for Investors," available at http://www.shareholderforum.com/appraisal/Program/20131209_AVR-summary.pdf.

[22] *See, e.g.*, Liz Hoffman, "Dell Buyout Critics Seek New Market for Appraisal Rights," Law360, June 21, 2013, available at www.law360.com.

Similarly, arbitrageurs have picked up on appraisal claims as fertile new ground for activity.[23] The managed fund market is flush with cash, and hedge funds facing stiff competition for returns are looking for unusual opportunities.[24] Funds may view these claims as a way to take advantage of Delaware's favorable interest rate, particularly in the current low interest rate environment. They may estimate a high likelihood of receiving at least the merger price as fair value for their shares, and possibly much more. If nothing else, the claims may be valuable as leverage for a lucrative settlement. Reportedly, some hedge funds have begun to specialize in appraisal rights—one having raised over $1 billion for that purpose—while some very large funds have begun to diversify into this area.[25]

Exemplifying the arbitrageur approach to appraisal claims is the ongoing Dole takeover battle. Dole shareholders were offered cash in a management buyout, and many shareholders were not satisfied with the offer price. The deal was approved by a bare majority, and afterwards, about one-quarter of Dole's shareholders exercised their appraisal rights. The dissenters included four large hedge funds, all of which purchased shares after the buyout was announced and all of which have filed appraisal actions in other transactions. The result is that Dole now faces a potential $190 million liability.[26] Should the hedge funds win a large payout, whether through settlement or adjudication, they and others will no doubt be encouraged to repeat this approach in other cash merger transactions.

The utility of appraisal rights suits to activists and plaintiffs' attorneys rests not only on the possibility of a large payout but also on the fact that no wrongdoing need be alleged or proven. The usual class action in the wake of a merger rests on allegations that the board of directors somehow breached its fiduciary duties to the shareholders, a very difficult claim on which to prevail under the business judgment rule, even under the higher judicial standard of enhanced scrutiny. By contrast, appraisal rights plaintiffs need only hope the court determines that the value of their shares exceeds the price paid in the merger—again, viewing the company as a going concern, and with significant interest component available.

It would appear that one formidable barrier to these suits' ever becoming prohibitive in M&A deals is that, in order for dissenters to have rights at all, a merger must first be consummated; this obviously requires the majority or supermajority of holders to accept the deal. However, there is a possibility that Delaware courts might entertain a cause of action known as "quasi-appraisal rights." These rights have been recognized when proxy materials were discovered, after the vote, to have contained material errors or omissions that might have influenced a shareholder's decision to dissent. All shareholders in quasi-appraisal have the right to pursue appraisal regardless of how they voted and even if they have already accepted cash for

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[23] *See, e.g.*, William Savitt, "Dissenters Pose Bigger Risks to Corporate Deals," Nat. L.J., Feb. 10, 2014, available at www.nationallawjournal.com/id=1202642062604/Dissenters-Pose-Bigger-Risks-to-Corporate-Deals?slreturn=20140225205634.

[24] *See, e.g.*, "Activists and Regulators: A Word from Rodgin Cohen," 14 M&A J. 7 (Feb. 2014).

[25] *See, e.g.*, Liz Hoffman, "Dole Food Deal Passes by Slim Margin as Hedge Funds Seek Appraisal," WSJ.com, Oct. 31, 2013, available at blogs.wsj.com/moneybeat/2013/10/31/dole-food-deal-passes-by-slim-margin-as-hedge-funds-seek-appraisal/.

[26] *See* Davidoff, *supra*.

their shares, with no risk that they would have to return any merger consideration if the appraised value ends up lower than the paid price per share. Quasi-appraisal is far from settled doctrine, but it potentially eliminates the significant downsides of both appraisal claims and traditional post-closing class action lawsuits, while threatening a target company with a potentially enormous payout owed to all shareholders.[27] Delaware courts presumably recognize the significant risk of inviting such disruptive litigation by making this claim available beyond a limited use as equitable remedy, but it remains to be seen if this doctrine will develop further.

It is not uncommon in merger agreements for acquirers to seek to include appraisal closing conditions, designed to allocate the risk of significant dissent to the seller and its shareholders. This type of condition states that if the percentage of dissenting shareholders is above a certain threshold—typically five to ten percent of the outstanding shares—the buyer no longer has an obligation to consummate the transaction. It is possible that these conditions may become more popular as a signal to arbitrageurs and activists that too-vigorous dissent may undermine a transaction completely. However, appraisal rights closing conditions can have the undesired effect of giving additional leverage to dissenters and should be considered carefully before being proposed by buyers.[28] In addition, sellers should shy away from accepting such conditions as they effectively transfer the risk of non-consummation back to the seller and may significantly increase the risk that the transaction at issue is not ultimately consummated.

Notably, revisions to Delaware law in 2013 may have an impact on appraisal claims. A new Section 251(h), designed to facilitate two-step mergers, now permits acquirers who comply with certain conditions to effect a squeeze-out merger without a shareholder vote if, after a tender or exchange offer, the acquirer owns the number of shares that would be needed to approve the merger agreement at a shareholder vote.[29] The new law eliminates the need for top-up provisions in two-step merger agreements; these provisions enabled an acquirer to purchase newly issued shares from the target, if necessary, in order to reach the 90 percent threshold required to effect a short-form merger. Under the new provision, shareholders now can be required by Delaware companies to make any demands for appraisal no later than the closing of the first-step offer. Previously, shareholders had been legally required to wait to exercise their appraisal rights until after the consummation of the second-step merger. Moreover, appraisal rights are available to target shareholders in all mergers effectuated under Section 251(h), including cashless exchange offers, which, if effectuated outside of the new provisions, do not give rise to appraisal rights.[30]

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[27] For a full discussion of quasi-appraisal case law in Delaware, see Robert B. Schumer et al., "Quasi-Appraisal: The Unexplored Frontier of Stockholder Litigation?" 12 M&A J. 2 (Jan. 2012).

[28] For a thorough discussion of appraisal closing conditions, see "Appraisal Arbitrage: Will It Become a New Hedge Fund Strategy?" Latham & Watkins M&A Deal Commentary, May 2007, available at www.lw.com/upload/pubContent/_pdf/pub1883_1.pdf.

[29] Del. Gen. Corp. L. § 251(h). Section 251(h) mergers are not available to "interested stockholders" (holding 15 percent or more of the target shares).

[30] Del. Gen. Corp. L. § 262.

Preparing for M&A Activism

Hedge fund activists may well be motivated by their recent success and newly acquired mainstream credibility to pursue energetic activity in 2014, particularly if M&A deal volume as a whole increases as predicted. In essential respects, preparing for shareholder activism in the M&A context is no different from preparing for shareholder activism generally. Companies should, as always, prioritize clear and frequent communication, meet with significant shareholders to hear and understand their concerns, and consistently articulate the long-term, strategic vision that the board is pursuing.

It may be a useful exercise for management and the board to take a step back and look at any proposed transaction from the perspective of an aggressive activist investor, in order to understand and take steps to minimize any potential vulnerabilities that could be exploited by activists. Currently, merger parties closely scrutinize the possibility of an interloper and include provisions in the merger agreement to allocate the risk of this possibility between the buyer and the seller. Potential target companies may want to consider structural takeover defenses in advance of beginning any extraordinary transaction process to ensure as much as possible that the target board maintains control over the transaction from start to finish. The possibility of activist attacks should be discussed during the negotiation stage of the transaction, so that any affected deal terms can be agreed upon and incorporated into the merger agreement and other documents. The deal partners should cooperate and work closely with their financial and legal advisors as well their communications teams to plan their response to any activist efforts to derail the transaction. Potential targets must keep track of any significant stock purchases occurring in the run-up to a deal and consider carefully the identity and goals of such buyers. In light of the scope and success of activist efforts in 2013, no company pursuing a significant transaction in 2014 should underestimate the potential impact of activist campaigns in the M&A context.