

Best Practices

The Rise of Appraisal Litigation: Will the Fire Spread?

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Appraisal actions allow shareholders who believe they will receive inadequate consideration in a merger transaction to dissent and petition the court to appraise the fair value of their shares. The Delaware courts have seen a sharp increase in shareholder rights appraisal litigation in recent years. This increase may be due to liberal standing requirements and the emergence of specialized hedge funds and activist investors that have learned how to make effective use of the appraisal remedy. This discussion (1) provides an overview of appraisal actions, (2) highlights several recent appraisal decisions in Delaware, (3) addresses potential reform efforts, and (4) analyzes prospects for future growth in appraisal actions in Delaware and in other jurisdictions.

INTRODUCTION

Appraisal litigation has emerged in recent years as the new “hot” area in litigation arising out of acquisitions. Indeed, a *Wall Street Journal* analysis found that a record 33 public company appraisal cases were filed in Delaware in 2014, with 20 more filed in the first four months of 2015.¹

Dissenting shareholder appraisal rights cases have become the newest battleground between corporations and activist investors. This surge in dissenting shareholder appraisal cases is due primarily to an increase in the use of appraisal arbitration by activist investors.

Appraisal arbitration refers to hedge funds and other activist investors acquiring target shares after an announcement of a public company merger with the goal of seeking appraisal rights under state statutory schemes.

The appraisal process allows shareholders who are dissatisfied with the consideration offered by the acquirer to petition a court for an appraisal of their shares’ “fair value.” What makes this attractive to activist investors, particularly in an atmosphere of low interest rates, is that the “return” on a successful appraisal action may yield a higher court-determined price plus interest at a statutory rate. Given the higher interest rates in the appraisal statutes, investors can realize quick returns.

Critics complain that the increase in appraisal arbitration may hinder otherwise constructive transactions and worry that buyers will offer less in anticipation of the capital they will lose when appraisal arbitrators strike. Proponents argue that appraisal arbitrators play an important role as specialists with the ability to hone in on deals and ensure that shareholders receive fair value.²

In this discussion, we describe appraisal actions and review recent trends, with a focus on Delaware—the epicenter for shareholder appraisal litigation. We also examine reasons why, despite the heightened focus on appraisal actions, the upswing in appraisal litigation in Delaware may not portend a similar tide of litigation in other jurisdictions that have enacted appraisal statutes.

Yet, even if the fire does not spread, the use of appraisal actions in Delaware shows no sign of abating any time soon.

BACKGROUND AND OVERVIEW OF APPRAISAL ACTIONS

The recent increase in appraisal litigation can be traced back to corporate law’s infancy. Corporate codes historically required unanimous shareholder approval before any merger or other fundamental corporate change could be accomplished.³

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Requiring unanimous consent understandably proved unwieldy and incentivized holdouts. Legislatures responded by removing unanimity requirements from their corporate codes, with appraisal rights emerging as a different and more manageable way to protect opposing noncontrolling shareholders.⁴

For example, Delaware law today allows shareholders who believe they will

receive inadequate consideration through a merger transaction to dissent from the merger and petition the court to appraise the fair value of their shares.⁵ A shareholder will then receive a court-determined fair value rather than the consideration offered by the acquiring company.

In Delaware, unlike in other states where appraisal may be sought following a sale of assets or an amendment to the company's certificate of incorporation, appraisal is only available in a merger.⁶ Appraisal actions are further limited to cash deals.⁷

The mechanics of an appraisal action require a shareholder to submit the question of value of his or her shares to a court. Appraisal actions are distinct from other shareholder actions in that neither party bears the burden of proving or defending wrongdoing; instead, both parties seek to demonstrate the fair value of the shares.⁸

The determination of fair value is the court's sole task. To determine fair value, a court evaluates the merger transaction and the fundamentals of the company's business to determine the present fair value of the company's stock. The shareholder takes the risk of the court setting a value *lower* than the price offered in the merger. This is because the court is not required to recognize the offer as a floor in the appraisal process.⁹

To support their claims in an appraisal hearing, parties commonly rely on valuation experts. And, each party's valuation expert advocates value based on the factors that lead to the highest (or lowest) price.¹⁰

This leaves the court in the position of refereeing a “battle of the experts” and deciding which expert's analysis more accurately encompasses fair value. Appraisal actions have come under criticism because they require courts to perform complex financial analyses, an endeavor that extends well beyond core legal expertise.¹¹

The only guidance Delaware law provides regarding the valuation process is that all relevant factors should be considered; these might include the historic trading price, bidding history during the sale process, deficiencies in the company's control or operations, and the industry's competitive landscape.¹²

A court may not consider value expected from the merger that is not yet ascertainable.¹³

Some recent decisions have used the negotiated merger price as the proper measure of fair value where the company embarked upon a competitive and arm's-length merger process, though courts traditionally rely on complex valuation processes absent evidence of price negotiations or a competitive bidding process.¹⁴

HIGHLIGHTS OF RECENT DELAWARE APPRAISAL ACTIONS

The increase in appraisal litigation has been fueled by a number of notable recoveries.¹⁵ For example, appraisal litigation proved worthwhile in the Energy Services Group merger, where shareholders were awarded \$15.9 million above the offering price (\$42,165,920 in total), representing a \$12 per share increase from the \$19.95 offering price.¹⁶

In reaching his decision, Chancellor Andre Bouchard relied on management projections that formed the basis for the merger price and made certain other conclusions regarding a discounted cash flow analysis and relevant tax consequences that resulted in a fair value award well above the merger price.

By contrast, Vice Chancellor Donald Parsons' recent decision in another appraisal action related to the Cypress-Ramtron merger limited a shareholder's recovery to the merger price.¹⁷

There, he rejected management projections that appeared litigation-driven and not in accordance with the reality of the business and instead placed great weight on a “proper transactional process.”

In particular, Parsons cited Ramtron's rejection of initial merger offers and efforts to identify other buyers, finding that these actions supported the ultimate merger price as a reflection of fair market value for valuation purposes.

APPRAISAL ARBITRAGE CONTROVERSY AND PROPOSED AMENDMENTS TO DELAWARE'S APPRAISAL STATUTE

Appraisal arbitrage has been credited—and criticized—as a major cause of the increase in appraisal

litigation. In this increasingly popular strategy, shareholder activists and hedge funds acquire a target company's shares *after* a merger announcement, oppose the deal, and then proceed to seek appraisal.¹⁸

While the appraisal remedy has been criticized as “cumbersome,” a “complicated maze,” “complicated and expensive,” with a “Byzantine procedure for asserting one’s appraisal rights,”¹⁹ increasingly sophisticated petitioners—specialized activist hedge funds who have learned how to effectively navigate the appraisal process by bringing multiple appraisal proceedings and have been rewarded with notable recoveries—have overcome these systemic obstacles.²⁰

Delaware’s liberal interpretation of standing requirements has enabled this type of arbitrage. This is because an appraisal action is available to plaintiffs who purchase stock in a company after the announcement of the merger, so long as they (1) make the proper demand requirements, (2) do not vote in favor of the merger or otherwise consent to it, and (3) hold the shares continuously through the effective date.²¹

The investors must forego the merger consideration and prove enough shares were not voted in favor of the merger to cover the number of shares seeking appraisal. But, if they meet those requirements, the plaintiffs have appraisal standing even for shares acquired after the record date.²²

Critics also blame another Delaware statutory feature for the rise in appraisal arbitrage: Delaware law allows appraisal awards to accrue and compound quarterly interest from the effective time of the merger through the appraisal judgment at a rate 5 percent over the Federal Reserve discount rate.²³

Interest compounding applies to the entire appraisal award. By extension, even if a court appraises fair value at a price lower than the deal consideration, the plaintiff still receives protection by virtue of the interest payments. Critics have raised concerns that these guaranteed interest payments provide another incentive for shareholders to lodge appraisal suits.²⁴

In response to these considerations, the Council of the Corporation Law Section of the Delaware State Bar Association has proposed two amend-



ments to the appraisal statute that address concerns about nuisance litigation in connection with the flux of appraisal arbitrage.

The first proposed amendment would (1) align Delaware law with minimum ownership standards already employed by other states and (2) require that all shareholders in an appraisal action involving a public company deal collectively hold at least 1 percent of the total shares entitled to appraisal or \$1 million worth of the shares measured in deal value.²⁵

As in other states, the amendment would set a floor of required appraisal petitions before the remedy becomes available.²⁶

The second proposed amendment would address supposed nuisance litigation by allowing the surviving company to pay each party seeking appraisal an amount of cash at the start of the action.²⁷ Interest would only accrue on the difference between the cash payment and the ultimate appraisal award.²⁸

This proposed amendment is meant to address the guaranteed compound interest award described above and remove any incentive the interest award alone might provide in encouraging otherwise meritless suits.

In sum, the amendments do not affect standing requirements and thus do not directly address the *modus operandi* of appraisal arbitrageur specialized hedge funds. Still, the amendments likely will constrain nuisance claims by minimizing unsubstantiated claims and reducing the economic enticement that accrued interest provides.

CONSTRAINING APPRAISAL LITIGATION GROWTH ELSEWHERE

Despite the increase in appraisal litigation and the heightened focus by specialized hedge funds and activist investors who have reaped rewards by playing the appraisal arbitrage game, there are several factors that may limit growth in appraisal litigation in other jurisdictions.

The most important of these relates to the interplay between the lower comparative market capitalization of non-Delaware mergers and the correspondingly reduced economic incentive and ability for appraisal arbitrageurs to get involved.

At the outset, it is important to recognize that the appraisal remedy is not limited to Delaware law. That high-profile appraisal claims are commonly brought in the Delaware Court of Chancery owes more to the state's status as the incorporation site of many prominent companies.²⁹

Yet, no fewer than 45 states and the District of Columbia have codified "dissenters' rights" statutes that allow dissenting shareholders to seek fair value for their shares.³⁰

Still, these statutes see less use than Delaware's. As examples, the New York appraisal remedy is contained in New York Business Corporation Law Sections 623 and 910. Section 623 has been cited a handful of times since 2014, while Section 910 has not been cited by any court since 2012.

The Ohio dissenting shareholder statute, Ohio Revised Code Section 1701.85, has not been cited since 2013. And, the Georgia statute, Official Code of Georgia Section 14-2-1302, has not been cited since 2007.

Moreover, many of the cases brought under other states' statutes involve smaller privately held corporations, rather than the large public corporations involved in Delaware appraisal actions. Hedge funds might not have any means for purchasing shares of private corporations, and even a small publicly held corporation may present a less attractive target to appraisal arbitrageurs. This is because the opportunity to achieve a significant return through appraisal arbitrage is lower.

In addition, the availability of key elements that enable and encourage hedge funds to jump into merger transactions and bring Delaware claims post-announcement—including the liberal standing requirements allowed by the Delaware courts and the generous guaranteed interest for appraisal awards—is less certain in other jurisdictions due to more limited statutory language, less developed jurisprudence, or both.

These limitations operate as a further brake on the spread of appraisal litigation and the arbitrage game into other jurisdictions. In light of these dynamics, among others, we have not observed marked growth in the use of state appraisal statutes outside of Delaware to date and do not anticipate this pattern will change in the immediate future.

FUTURE OF APPRAISAL LITIGATION

Appraisal litigation remains a hot issue in the Delaware courts. It is anticipated, absent legislative reform, that activist investors will continue to use the liberal standing requirements and potential high interest awards to challenge public company mergers using the Delaware appraisal statute as their weapon of choice.

What remains to be seen is whether the notable recoveries in the Delaware courts will encourage activist investors to pursue appraisal actions in other jurisdictions.

It is not anticipated that appraisal litigation will spread to other states because the statutory schemes in other jurisdictions are not uniform in scope and application, among other reasons.³¹

Nonetheless, because most jurisdictions have appraisal statutes, motivated parties may test the appraisal litigation waters following the announcement of a public company merger or going-private transaction.

Notes:

1. Liz Hoffman, "Wall Street Law Firms Challenge Hedge-Fund Deal Tactic," *Wall Street Journal*, (April 6, 2015).
2. Charles Korsmo and Minor Myers, "Shareholder Litigation That Works," *New York Times* (April 16, 2015).
3. See Charles Korsmo and Minor Myers, "The Structure of Stockholder Litigation: When Do the Merits Matter?" 75 *Ohio State Law Journal* 829 (2014).
4. *Id.*; 8 Del. C. § 262(b).
5. 8 Del. C. § 262.
6. *Id.*
7. *Id.*
8. See *In re Appraisal of Ancestry.com, Inc.*, C.A. No. 8173-VCG, 2015 Del. Ch. LEXIS 21, at *3 (Del. Ch. Jan. 30, 2015).
9. See *Gearreald v. Just Care, Inc.*, C.A. No. 5233-VCP, 2012 Del. Ch. LEXIS 91 (Del. Ch. Apr. 30, 2012) (court found that fair value of company for appraisal purposes was \$6 million less than merger price); Jeremy D. Anderson and José

- P. Sierra, "Unlocking Intrinsic Value Through Appraisal Rights," *Law360*, Sept. 10, 2013 (in 8 of 45 appraisal cases reviewed, appraisal of fair value by the court was less than the merger price).
10. See *Merlin Partners LP v. AutoInfo Inc.*, C.A. No. 8509-VCN, 2015 Del. Ch. LEXIS 128 (Del. Ch. Apr. 30, 2015).
 11. See *Ancestry.com*, *supra* n.8, 2015 Del. Ch. LEXIS 21, at *2 (noting the "difficulties, if not outright incongruities, of a law-trained judge determining fair value of a company in light of an auction sale, aided by experts offering wildly different opinions on value").
 12. *AutoInfo*, *supra* n.10.
 13. *Id.*; 8 Del. C. § 262(h) (providing that determination of fair value be "exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation").
 14. Compare *AutoInfo*, *supra* n.10 (using merger price as fair value) and *Ancestry.com*, *supra* n.8 (same) with *Laidler v. Hesco Bastion Envtl., Inc.*, C.A. No. 7561-VCG, 2014 Del. Ch. LEXIS 75 (Del. Ch. May 12, 2014) (using direct capitalization of cash flow method).
 15. See Karlee Weinmann, "Chancery Dings Appraisals, But Deal Makers Still Vulnerable," *Law360*, Feb. 2, 2015; Karlee Weinmann, "M&A Cases to Watch in 2015," *Law360*, Jan. 2, 2015.
 16. *Owen v. Cannon*, C.A. No. 8860-CB, 2015 Del. Ch. LEXIS 165 (Del. Ch. June 17, 2015); Amaris Elliott-Engel, "Appraisal Gains Major Shareholder \$16M in Value After Merger," *Delaware Business Court Insider*, June 24, 2015.
 17. *LongPath Capital, LLC v. Ramtron Int'l Corp.*, C.A. No. 8094-VCP, 2015 Del. Ch. LEXIS 177 (Del. Ch. June 30, 2015).
 18. The hedge fund Merion Capital LP pursued this strategy in the *Ancestry.com* and *BMC Software* buyouts. *Merion Capital LP v. BMC Software, Inc.*, C.A. No. 8900-VCG, 2015 Del. Ch. LEXIS 3 (Del. Ch. Jan. 5, 2015); *In re Appraisal of Ancestry.com, Inc.*, C.A. No. 8173-VCG, 2015 Del. Ch. LEXIS 2 (Del. Ch. Jan. 5, 2015).
 19. See Minor Myers and Charles Korsmo, "Appraisal Arbitrage and the Future of Public Company M&A" 92 *Washington University Law Review* __ (forthcoming 2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2424935.
 20. *Id.*
 21. See *BMC Software*, *supra* n.18; *In re Appraisal of Transkaryotic Therapies, Inc.*, C.A. No. 1554-CC, 2007 Del. Ch. LEXIS 57 (Del. Ch. May 2, 2007).
 22. See *BMC Software, Inc.*, *supra* n.18.
 23. 8 Del. C. § 262(h)-(i).
 24. Hoffman, "Wall Street Law Firms Challenge Hedge-Fund Deal Tactic," *supra* n.1. ("Also encouraging funds to mount the campaigns: They are guaranteed interest equivalent to 5.75% annually on the value of their stakes as the appraisal review takes place. That amount, established during a period of higher interest rates, is especially attractive amid today's low yields.")
 25. Steven Davidoff Solomon, "A Three-Pronged Front to Limit Shareholder Litigation," *New York Times* (April 2, 2015).
 26. *Id.*
 27. *Id.* Note that Vice Chancellor Sam Glasscock discussed this approach in *Huff Fund Inv. P'ship v. CKx, Inc.*, but declined to adopt it given the lack of statutory authorization. C.A. No. 6844-VCG, 2014 Del. Ch. LEXIS 18 (Del. Ch. Feb. 12, 2014), *aff'd*, No. 348, 2014, 2015 Del. LEXIS 77 (Del. Feb. 12, 2015).
 28. Solomon, "A Three-Pronged Front to Limit Shareholder Litigation," *supra* n.25.
 29. Delaware's appraisal statute permits "[a]ny stockholder of a corporation of this State" to bring appraisal actions in "the Court of Chancery." 8 Del. C. § 262(a).
 30. See *Pueblo Bancorporation v. Lindoe, Inc.*, 63 P.3d 353, 364-369 (Colo. 2003) (surveying state laws).
 31. Note that many states have modeled their dissenters' rights statutes off of the Model Business Corporation Act (MBCA); of these states, "five have adopted the definition of 'fair value' found in the 1999 amendments to the MBCA and another twenty-seven . . . have a definition that is identical or nearly identical to that found in the 1984 MBCA." *Pueblo Bancorporation*, *supra* n.30, at 365.

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