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Mergers & Acquisitions

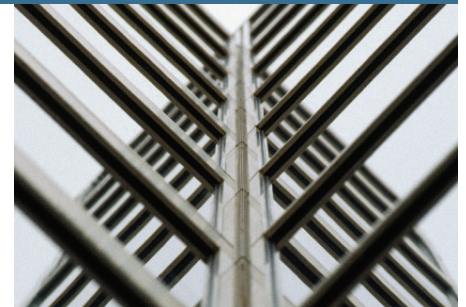
April 2015

Increasing Hostility Towards Appraisal Arbitrage

Appraisal rights have become increasingly popular and controversial in recent years. While statutory appraisal remedies are intended to protect minority stockholders by enabling those who dissent to request a judicial determination of the fair value of their shares in a takeover context, this public policy rationale is absent from the current trend of increasing appraisal claims brought by institutional investors that engage in "appraisal arbitrage" as they invest in target companies upon a takeover announcement with the intention of exercising appraisal rights.

Appraisal arbitrage gained momentum as an investment strategy after the Delaware Chancery Court's 2007 decision in *In re Appraisal of Transkaryotic Therapies, Inc.* in which it held that appraisal rights are no longer limited to stockholders on the record date, but extend to anyone who holds stock up until the stockholder meeting, even if acquired after the record date. The *Transkaryotic* decision has enabled arbitrageurs to reduce the duration of their investment and to shoulder less deal risk by making their investment later in the process. The Chancery Court's approach to appraisal rights continues to evolve as earlier this year in *In Re Appraisal of Ancestry.com, Inc.* and *Merion Capital LP v. BMC Software, Inc.* the Court held that the Delaware appraisal statute does not require stockholders to prove that they or the prior owners of the particular shares they seek to be appraised were not voted in favor of the merger. While the net effect of these two recent decisions has yet to be seen, the current interest rate environment unambiguously favors appraisal claims as the default interest rate under the Delaware General Corporation Law ("DGCL") earned while a stockholder's appraisal claim is pending is 5% over the Federal Reserve discount rate and it is payable on the final appraisal award even if such amount is less than the merger consideration paid to non-dissenting stockholders. According to the Wall Street Journal, a record 33 public appraisal cases were filed in Delaware in 2014.

In response to these developments, the Delaware Corporation Law Council announced proposed amendments to the DGCL, which are expected to be introduced to the Delaware legislature and, if adopted, take effect on August 1, 2015. The amendments put forth by the Council include reforms to Section 262 of the DGCL that would reduce the economic incentive for stockholders to bring appraisal proceedings. The proposed reforms provide that (i) other than in "short-form" mergers where appraisal may be the minority stockholders' only remedy, stockholders must hold at least 1% of stock entitled to appraisal rights or US\$1 million of merger consideration in order to bring an appraisal suit in relation to certain public company mergers and (ii) the company surviving a merger can elect to pay dissenting stockholders cash while an appraisal claim is pending, limiting the accrual of interest to interest on the difference between the final appraisal award and the cash payment.



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Despite the expectation that the proposed legislative reforms will be adopted by the Delaware legislature, they have been criticized as insufficient to effectively address the problems of appraisal arbitrage and were most recently the subject of a letter from seven New York law firms on April 1st addressed to the Council of the Corporate Law Section of the Delaware Bar Association where it was argued that the proposed amendments would merely dampen rather than eliminate the issue. The proposed restrictions on the equity holdings of dissident stockholders are not expected to have a significant impact on the prevalence of appraisal arbitrage as *de minimis* appraisal claims are atypical given the substantial cost and effort required to bring an appraisal suit. In addition, the proposed reforms have been criticized for failing to address the disconnect between the public policy objective of appraisal rights as a dissenter's remedy and the Chancery Court's willingness to forego any requirement that the stockholders seeking an appraisal award actually oppose the takeover in a stockholders' vote or have a longer-term investment horizon. Failure to adequately address the rising trend of appraisal arbitrage risks creating incentives for buyers to lower their price in anticipation of having to pay appraisal arbitragers post-closing and therefore shifting value away from long-term stockholders towards short-term arbitragers without advancing the underlying public policy rationale for appraisal rights. Thus, there is a renewed effort on the part of the corporate bar to lobby for amendments to the DGCL in order to make express that appraisal rights are not available to stockholders with no right to vote on, and therefore dissent from, the transaction. As dealmakers and the Delaware courts and legislature continue to develop their positions, we expect the debate over appraisal rights to continue to evolve in the coming months.

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