Section 262 Appraisal Amendments

The purpose of this paper is to summarize briefly the considerations leading to the currently proposed amendments for Delaware's appraisal statute, Section 262 of the Delaware General Corporation Law ("DGCL").

Background

In February 2014, the Council of the Corporation Law Section of the Delaware State Bar Association (the "Council") appointed a subcommittee comprised primarily of Council members to study the desirability of amendments to Section 262. Creation of the subcommittee arose in part because of increasing commentary about "appraisal arbitrage" and whether it is consistent with the intended purpose of the appraisal statute.[1] Appraisal arbitrage is generally understood to be the acquisition of shares with attendant appraisal rights purchased after the public announcement of a planned merger. Successful appraisal arbitrage anticipates that the merger will be consummated, appraisal rights will be perfected and the recovery (including interest) will provide a favorable return.

The subcommittee initially considered whether to modify Section 262 to eliminate or limit appraisal arbitrage. Several considerations led the subcommittee to recommend and Council to conclude that the statute should not limit appraisal rights to shares held before the public announcement of a proposed transaction. Council does not believe appraisal arbitrage upsets a proper balance between the

ability of corporations to engage in desirable value enhancing transactions and the ability of dissenting stockholders to receive fair value for their holdings.

- Delaware law since at least 1989 explicitly has 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.[2]

- Recent case law has suggested that a market test of a transaction will serve as a proxy for fair value in appraisal suits, so that arm's-length deals with adequate market checks do not create appraisal risks for buyers.

- Where transactions cannot be subject to a market check for structural reasons (such as buy outs by controlling stockholders who are unwilling to sell), fiduciary duties and litigation may not be sufficient to ensure that the merger price reflects the fair value of the acquired shares.

- 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. The assignment and acquisition of financial claims (in contrast to tort claims) generally has been accepted historically and presently as lawful and consistent with public policy.[3]

- Studies of appraisal arbitrage do not suggest that it encourages frivolous litigation. Unlike the case of representative litigation, which occurs in more than 90% of the public mergers and consolidations, only 17% of the appraisal eligible transactions during 2013 resulted in appraisal litigation in Delaware.[4]

- Appraisal cases seem to be self-selecting, attacking primarily conflict transactions or transactions involving questionable pricing. Such transactions, which have a greater potential for unfairness and frequently result in appraisal awards at a premium to the merger price, sometimes a very significant premium.[5]

- Appraisal 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.[6]

- To 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). The fact that such appraisal-out conditions remain fairly rare suggests that the availability of appraisal arbitrage is not a significant factor in the market.

The Legislative Proposals

The Council proposes two modifications to Section 262 to improve its operation. The first modification limits pursuit of otherwise qualified appraisal claims in public company transactions if the claim is *de minimis*. The second modification addresses the concern that appraisal arbitrageurs may be incented to pursue claims simply because of the amount of interest they would be able to recover on the award. It gives corporations options to prevent interest arbitrage.

A. The *De Minimis* Exception

The proposed legislation would amend Section 262(g) to impose limits on the availability of a judicial determination and award of fair value where the otherwise eligible appraisal shares have been traded on a national securities exchange. If 99% of the stockholders accept the merger consideration, or the amount in dispute is less than or approaches the cost of litigation, it is difficult to justify the use of judicial and party resources to provide a judicial determination of value. Thus, the amendment would permit a surviving corporation in a merger or consolidation to obtain dismissal of an otherwise perfected appraisal claim unless (i) the total number of shares entitled to appraisal exceeds 1% of the outstanding

number of shares that could have sought appraisal; or (2) the value of the merger consideration for the total number of shares entitled to appraisal exceeds $1 million; or (iii) the merger was approved pursuant to Section 253 or Section 267. Appraisal rights would be precluded unless the dispute with regard to valuation meets a minimum threshold of significance measured by the number of dissenters or the amount in dispute. Surmounting one of these hurdles minimizes risk that appraisal will be used to achieve a settlement simply because of the nuisance value of discovery, the cost of financial experts and other burdens of litigation. Section 253 and Section 267 short form mergers are not subject to the appraisal limitation because appraisal may be the only remedy available.[7] The *de minimis* carve-out will apply only to shares traded on a national securities exchange. The difficulty of valuing the merger consideration in a private company and the unlikely prospect that the one percent threshold would not be met counseled against providing a *de minimis* exception in cases not involving shares traded on a national securities exchange.

B. The Corporation's Option to Pay and Limit the Accrual of Interest

The proposed amendment to Section 262(h) would provide corporations the option of limiting the accrual of interest on appraisal awards. Since 2007, Section 262(h) generally provides for an award of interest equal to Delaware's legal rate of interest – the Federal Reserve discount rate plus 5%.[8] That amendment was

designed to simplify the appraisal proceeding and limit the amount of time previously spent by the parties, the court and experts on determining a proper rate of interest.[9] Some commentators and practitioners became concerned that the statutory interest rate, which for the last several years has provided an attractive rate relative to money market and government yields, encouraged interest arbitrage by appraisal claimants. Empirical studies cast doubt on this supposition and hedge funds openly engaged in appraisal arbitrage have substantially greater investment return targets than the legal rate.[10] The Council, however, believes corporations should have the option to cut off the accrual of interest by paying to the appraisal claimants a sum of money of the corporation's choosing. Thereafter, with respect to the amount paid, interest would not accrue. Interest would only accrue if the judicial award exceeded the amount paid, and then would accrue only on the excess. The corporation exercising this option would need to pay all claimants unless there is a good faith basis for contesting a stockholder's entitlement to appraisal. Payment pursuant to this option would not give rise to any inference with respect to the fair value of the shares to be appraised. The option this amendment would afford corporations would permit them to make a rational choice about the relative cost of paying or retaining all or a portion of the merger consideration during the pendency of the dispute.

Because respondent corporations would have this option, the incentive for interest rate arbitrage will be dampened without compromising the interests of pre-existing equity holders. The reason for that is that interest rate arbitrage investors cannot depend on receiving the statutory rate as to most of the merger consideration, because a respondent could immediately tender, for example, 75% of the transaction price, thus reducing the petitioners' ability to get the statutory rate as to the bulk of the amount likely to be due at the end of the proceeding. As a result, the amendment better ensures the appraisal actions will be motivated by a genuine interest in proving that the transaction price was unfair.

Effective Date

The proposed legislation provides for the amendments to be effective with respect to merger or consolidation transactions pursuant to agreements first entered into on or after August 1, 2015. It would not affect pending litigation.

[1] *See, e.g.,* Fried Frank M&A Briefing (6/18/14), *New Activist Weapon, The Rise of Delaware Appraisal Arbitrage: A Survey of Cases and Some Practical Implications; Kobi Kastiel, Why Delaware Appraisal Awards Exceed the Merger Price*, http.blogs.law.harvard.edu/corpgov/2014/09/23.

[2] *Salomon Brothers Inc. v. Interstate Bakeries Corporation,* 576 A.2d 650 (Del. Ch. 1989).

[3] 6 *Del. C.* § 2702 (assignees of bonds, specialties and notes may enforce in their own name); 10 *Del. C.* § 3902 (assignees of contracts may enforce in their own name); Lauren D. Gojkovich, *Leveraging Litigation: How Shareholders Can Use Litigation Leverage to Double Down on Their Investment in High Stakes Securities Litigation*; 16 STAN. L.J. Bus. & Fin., 100, 111 (2010).

[4] Steven Epstein, Philip Richter, et al., *Keeping Current: Delaware Appraisal: Practical Considerations*, BUSINESS LAW TODAY, 1 (October 2014); Myers, Minor and Korsmo, Charles, *Appraisal Arbitrage and the Future of Public Company M&A* (April 14, 2014) forthcoming, 92 Washington University Law Review ____ at 1-5, 41-47 (2015) Brooklyn Law School Legal Studies Paper No. 388 (hereinafter "Korsmo & Myers (2014)").

[5] *Id.*

[6] *Id.*

[7] *Glassman v. Unocal Exploration Corp.,* 777 A. 2d 242 (Del. 2001)

[8] 6 *Del. C.* § 2301.

[9] *See e.g. Lebman v. National Union Electric Corp.,* 441 A.2d 824 (Del. Ch. 1980); Dole Transcript (2015) at 24-26.

[10] Korsmo & Myers (2014) at 2, 24-25.