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NEW YORK OFFICE

250 Park Avenue
Seventh Floor
New York, NY 10177
Tel: (646) 453-7288
Fax: (646) 453-7289

GREAT NECK OFFICE

111 Great Neck Road
Suite 201
Great Neck, NY 11021
Tel: (646) 453-7288
Fax: (646) 453-7289

NEW JERSEY OFFICE

411 Hackensack Avenue
2nd Floor
Hackensack, NJ 07601
Tel: (646) 453-7292
Fax: (646) 453-7289

Hung G. Ta, Esq.
hta@hgtlaw.com

JooYun Kim, Esq.
jooyun@hgtlaw.com

Natalia Williams, Esq.
natalia@hgtlaw.com

Protecting Investors in Mergers and Consolidations: Appraisal Rights

Appraisal rights are a statutory remedy available under Delaware law to objecting shareholders in certain transactions, typically a merger or consolidation. This memorandum focuses on Delaware law because more than half of all public traded companies in the U.S. and nearly two-thirds of the Fortune 500 companies are incorporated in Delaware.

1) What are appraisal rights?

Shareholders who oppose a merger or consolidation have the option to exercise appraisal rights under Delaware law. Instead of accepting the price being offered by an acquirer, a shareholder can petition the Delaware Chancery Court to determine the fair value of its shares. Historically, appraisal rights litigation has not been significant, but it has recently become more prominent in mergers and consolidations, with both the number and value of appraisal cases in Delaware rising.

2) What types of merger or consolidation transactions trigger appraisal rights?

Appraisal rights are not available for mergers or consolidations involving companies that are listed on a national securities exchange or that have more than 2,000 record shareholders. However, the exception to this rule is where the shareholder is required to accept any merger consideration other than: (a) stock of the surviving corporation; (b) stock of another company listed on an exchange or held by more than 2,000 shareholders; and/or (c) cash in lieu of fractional shares.¹ In other words, in the case of public companies, appraisal rights will be available where the shareholders are required to receive cash in consideration for their shares.

3) Which shareholders can exercise appraisal rights?

A shareholder of a Delaware corporation may exercise appraisal rights if the shareholder: (a) holds its shares on the date the demand for appraisal is made; (b) continuously holds the shares through the effective date of the merger or consolidation; and (c) has neither voted in favor of the transaction nor has consented to it in writing.²

Notably, an investor does not need to have been a shareholder at the time the merger was announced. An investor can acquire the shares after the record date, but before the merger vote, and still assert appraisal rights. Accordingly, investment funds have been set up to acquire stock in companies that are the subject of merger announcements, and then pursue an appraisal, referred to by some commentators as “appraisal arbitrage.” See Question 11 for more on appraisal arbitrage.

4) What are the advantages of exercising appraisal rights?

There are several significant advantages to exercising appraisal rights.

First, in pursuing appraisal rights, plaintiffs have historically obtained greater returns than the merger price. According to one study, since 2010, the court's appraisal determinations have exceeded the merger price in all but two cases, with the appraisals representing premiums over the merger price ranging from 8.5% to 149% (with an average of 61%). Also, shareholders who pursue appraisal can obtain a higher price without actually proceeding to litigation, by negotiating with the acquirer during the time between the effective date of the merger and the date an appraisal court proceeding must be commenced. *See* Question 9 for more on the historical returns.

Second, the shareholder need not own the stock on the date the merger is announced, but only as of the effective date of the merger. This means that, after a particular transaction is announced, an investor has the opportunity to evaluate whether appraisal rights are worth pursuing and then purchase a large position in the company solely for purposes of pursuing an appraisal.

Third, unlike breach of fiduciary duty or securities fraud lawsuits, wrongdoing need not be alleged or proven in appraisal rights cases because the shareholder is only asking the court to determine the fair value of a company's stock. A plaintiff can obtain fair value for the stock even if the fiduciaries involved in the transaction acted in good faith. The evidence that determines the outcome of the appraisal proceeding generally consists of expert reports and testimony on the value of the company.

Fourth, an appraisal lawsuit does not proceed as a conventional class action. Only those shareholders who meet certain procedural requirements may pursue an appraisal, resulting in a form of aggregate litigation where the plaintiffs have much more control over the lawsuit. There is also generally a direct payment of any judgment or settlement to the shareholder.

Fifth, the shareholder who pursues an appraisal earns interest on its ultimate recovery calculated at highly favorable rates. During the period between the effective date of the merger and the date of payment of the judgment, the shareholder earns interest at a rate of 5% over the Federal Reserve discount rate, compounded quarterly. This rate may only be varied by the court if good cause is shown.³

5) What are the disadvantages of exercising appraisal rights?

Despite the significant benefits of pursuing appraisal rights, there are disadvantages that also need to be considered.

First, the court may return an appraisal that is less than the merger price offered. Although the historical results have generally been favorable in appraisal proceedings, because the courts have significant discretion in determining fair value, it is possible for shareholders to receive payment equal to or less than the merger price. Additionally, unlike actions involving breach of fiduciary duty or fraud, the appraisal remedy is limited in scope to the fair value of the shares. This point highlights the importance of evaluating and selecting an appropriate case for appraisal. *See* Question 10 for more on the best cases for pursuing appraisal rights.

Second, shareholders must strictly adhere to a rigorous procedure when exercising appraisal rights. *See* Question 6 for more on perfecting appraisal rights.

Third, appraisal proceedings are costly and the shareholder must initially pay for its own expenses. However, these costs are typically split amongst all shareholders seeking appraisal because a court will order all or a portion of the expenses incurred (including reasonable attorney's fees and costs of experts) to be charged pro rata against the value of all the shares pursuing the appraisal.

Fourth, appraisal proceedings may be lengthy and can take anywhere from several months to several years.

Fifth, the shareholder must forego the merger consideration and will lose rights generally associated with the stock (for example, receiving dividends and voting).⁴

6) What are the procedural requirements for asserting appraisal rights?

A shareholder must strictly comply with the following procedural requirements in order to pursue and maintain its appraisal rights:

- The shareholder must file a written demand for an appraisal with the corporation either:
 - ◊ before the shareholders' meeting to vote for approval of the merger; or
 - ◊ within 20 days from when the company mails notice to the shareholders informing them the merger has been approved (where there is a short-form merger or a merger approved by written consent of the shareholders).⁵
- The written demand must reasonably inform the corporation of the identity of the shareholder and that the shareholder intends to demand the appraisal of its shares.⁶
- If a vote on a merger or consolidation is required, the shareholder must either vote against the merger or abstain from voting.
- The shareholder must not accept the merger consideration.⁷
- The shareholder must continuously be a record holder from the date of the demand for appraisal through the effective date of the merger.⁸ A broker who holds stock on behalf of beneficial owners may exercise the appraisal remedy on behalf of its client.
- A shareholder may withdraw its appraisal demand any time within 60 days after the effective date of the merger, if the shareholder has not commenced an appraisal proceeding or joined a proceeding as a named party. Upon withdrawal of the appraisal demand, the shareholder is entitled to accept the terms of the merger.⁹
- Within 120 days after the effective date of the merger, a shareholder who has perfected its appraisal rights in accordance with the above procedures must then file a petition with the Delaware Court of Chancery demanding an appraisal. The surviving corporation itself can also initiate the appraisal proceeding. During the 120-day window, dissenting shareholders may

attempt to negotiate a settlement with the company. If a petition is not filed within the 120-day period, the appraisal rights of all shareholders who demanded appraisal lapse.

- Once a petition has been filed, the court's approval is required to dismiss or settle an appraisal proceeding.¹⁰ A shareholder who commences an appraisal proceeding and then inadvertently tenders its shares to the corporation is still bound by the court's ruling on the appraisal proceeding.

7) What happens after a petition is filed with the court?

If all the procedural requirements are followed, the court will schedule a hearing. The Register in Chancery will give notice to the surviving corporation and to all the dissenting shareholders.¹¹

At the hearing, the court will determine the shareholders who have complied with the applicable procedural requirements and who have become entitled to appraisal rights. The shareholder has the burden of showing that it has complied with the statutory requirements for demanding appraisal.¹²

After these preliminary steps are complete, the litigation continues. The court then receives evidence and determines the fair value of the shares.¹³

8) How does the court determine fair value?

The court has a significant amount of discretion in determining fair value¹⁴ and typically focuses on expert testimony. Both the dissenting shareholders and the corporation bear the burden of establishing fair value by a preponderance of the evidence (*i.e.*, the purported value is more likely than not to be fair).

In making its determination, the court must take into account all relevant factors, but must exclude any element of value arising from the consummation or expectation of the merger.¹⁵ Although the court does not give presumptive weight to the merger price, it is not required to completely ignore that price. Additionally, the value of the company is determined as of the merger date, and not as of the offer date.

The court may use any financial analysis method that is generally accepted by the financial community to determine going-concern value. In most cases, the court relies on the discounted cash flow analysis, which calculates the present value of a company's future free cash flows by discounting the cash flows at a determined discount rate. This is the method that is also the most used by, and merits the greatest confidence in, the financial community. Where appropriate, the court may also use a comparable company or transaction analysis. Under either of these analyses, similar companies or transactions are used as benchmarks or models for the court's valuation. The limitation with these methods is that a comparable company or transaction must exist to make the analysis appropriate.

9) What have been the historical returns for shareholders exercising appraisal rights?

In the past, the results of appraisal rights lawsuits have generally been favorable to the dissenting shareholder. According to one review, over 80% of Delaware appraisal rights cases resulted in a court finding fair value higher than the merger consideration.¹⁶ Another study found that, between 2010 and June 2014, the court's

appraisal determinations have exceeded the merger price in all but two cases, with the appraisals representing premiums over the merger price ranging from 8.5% to 149% (with an average of 61%).¹⁷

In earlier years, before the recent sharp rise in appraisal rights cases, courts similarly issued appraisal determinations that were higher than the transaction price in the vast majority of cases. Specifically, between the years 2000 and 2007, the court found appraisal premiums in the range of 5% to 471%. Including two cases where the court found the fair value to be below the merger price, the average for these years was a premium of about 111%.¹⁸

10) What are the best cases in which to pursue appraisal rights?

Based on a review of recent appraisal decisions, the best cases for pursuing appraisal rights are those cases where the merger or consolidation is an “interested” transaction, such as where management of the company and/or a majority shareholder seeks to take the company private by buying out the public shareholders. Because the required return on capital for private equity is usually higher than the return on equity demanded by public shareholders, the value of the company will, almost by definition, be higher than the price being offered by the “interested” acquirer.

Recent appraisal determinations confirm this. According to one review, in “interested” transaction cases from 2010 to 2014, appraisal determinations were between 19.5% to 148.8% over the merger price (an average of 80.5%).¹⁹

In contrast, according to the same review, in the four appraisal cases involving arm’s-length mergers over the same period of time: two determinations were at a premium above the merger price, but only by 8.5% and 15.6%; one determination was equal to the merger price; and one determination was 14.4.% below the merger price.²⁰

In other words, it is important to be selective when pursuing appraisal rights.

11) What is appraisal arbitrage?

In recent years, appraisal rights proceedings have increased significantly due, in part, to the rise of sophisticated investors, who buy large positions in companies after the announcement of a merger or consolidation. These investors make a strategic decision to invest in a company based on a calculation that they will receive more in an appraisal proceeding than the merger price. This practice is known as “appraisal arbitrage.”

12) Whom can I contact if I wish to find out more about appraisal rights unde Delaware law?

If you wish to learn more about shareholder appraisal rights under Delaware law, please contact us by email (hta@hgtlaw.com or jooyun@hgtlaw.com) or by telephone (+1 646-453-7290).

ENDNOTES

1. Delaware General Corporation Law (“DGCL”) Section 262(b).
2. DGCL § 262(a).
3. DGCL § 262(h).
4. DGCL § 262(k).
5. DGCL § 262(d)(1)-(2).
6. DGCL § 262(d)(1).
7. DGCL § 262(k).
8. DGCL § 262(a).
9. DGCL § 262(e).
10. DGCL § 262(k).
11. DGCL § 262(f).
12. DGCL § 262(g).
13. DGCL § 262(h).
14. *Id.*
15. *Id.*
16. David A. Katz & Laura A. McIntosh (Wachtell, Lipton, Rosen & Katz), *Corporate Governance Update: Shareholder Activism in the M&A Context*, New York Law Journal (Mar. 27, 2014) (citing Jeremy D. Anderson & Jose P. Sierra (Fish & Richardson), *Unlocking Intrinsic Value Through Appraisal Rights*, Law360 (Sept. 10, 2013) (review of Delaware appraisal cases in the 20 years up through 2013)).
17. Steven Epstein, Philip Richter, David Shine & Gail Weinstein (Fried Frank Harris Shriver & Jacobson), *Why Delaware Appraisal Awards Exceed Merger Price*, Law360 (Oct. 2, 2014). *See also* Appendix A.
18. Stephen A. Radin, *The Business Judgment Rule*, 1572-1575 (6th ed. 2009). *See also* Appendix B.
19. Epstein, *Why Delaware Appraisal Awards Exceed Merger Price*. *See also* Appendix A.
20. *Id.*

APPENDIX A

Delaware Appraisal Decisions: 2010 through August 2014 (in descending order by size of premium of appraisal fair value over merger price)

Date	Case	Merger Price	Court's Fair Value Appraisal/ Valuation Method	Premium Over Merger Price [additional premium represented by statutory interest]	Respondent's Fair Value/ Petitioner's Fair Value	Type of Transaction	Special Committee	Majority of Minority Vote	Market Check
INTERESTED TRANSACTIONS									
2/15/10	<i>In re Sunbelt Beverage</i>	45.83	114.04 DCF	148.8% [213.8%]	36.30 114.04	Controlling stockholder squeeze-out merger	No – In addition, fairness opinion was wholly deficient	No	No
7/18/12	<i>In re Orchard Enterprises</i>	2.05	4.67 DCF	127.8% [36.1%]	1.53 5.42	Controlling stockholder squeeze-out merger	Yes – but Chair had deep ties to controlling stockholder and made post-merger arrangements with surviving company	Yes	Weak – Go-shop; no proposal received
6/25/14	<i>Laidler v. Hesco</i>	207.50	387.24 DC	86.6% [24.7%]	250.30 515	90% short-form merger	No	No	No
6/28/13	<i>Towerview v. Cox Radio</i>	4.80	5.75 DCF	19.8 [26.9%]	4.28 2.12	90% short-form merger after tender offer (6 of 8 directors affiliated with acquisition)	Yes – the 2 independent directors	No – although tender offer had a majority of the minority tender condition	No
4/23/10	<i>Global v. Golden Telecom</i>	105	125.49 DCF	19.5% [14.7%]	88 139	2 largest shareholders of acquiror (44% and 34%) were also 2 largest stockholders of target (25% and 18%). (Majority of acquiror's board and large portion of target's board had been appointed by these shareholders)	Yes – the directors not affiliated with the 2 stockholders	No	No – Court determined that post-signing "passive market check" (that produced no proposal) was irrelevant without guarantees by the 2 stockholders that would support a higher bid if made
DISINTERESTED TRANSACTIONS									
3/18/13	<i>IQ v. Am. Comm. Lines</i>	33	38.16 DCF	15.6% [13.7%]	-- --	3 rd party merger	--	--	Weak – Go-shop; no proposal received
7/18/13	<i>Merion v. 3M Cogent</i>	10.50	10.8% DCF	8.5% [14.3%]	10.12 16.26	3 rd party merger	--	--	Yes – but, as neither party relied on merger price, court deemed it "irrelevant"
11/1/13	<i>Huff v. CKx</i>	5.50	5.50 merger price	0%	4.41 11.02	3 rd party merger	--	--	Yes – full competitive auction
4/30/12	<i>Gearrakl v. Just Care</i>	40M (whole company)	34.24M DCF	(-14.4%) [11.7%]	33.6M 55.2M	3 rd party merger	--	--	No – but 1 unsolicited proposal was received

This chart was taken from the Fried Frank publication referenced at footnote 17, as published in The Harvard Law School Forum on Corporate Governance and Financial Regulation, available at: <http://blogs.law.harvard.edu/corpgov/2014/09/23/why-delaware-appraisal-awards-exceed-the-merger-price/#more-65720>.

APPENDIX B

Historical Results in Delaware Appraisal Actions 2000-2007

Decision	Transaction Price Per Share	Appraisal Price Per Share	Appraisal Premium/ Discount
<i>Hintmann v. Fred Weber, Inc.</i> , 2000 WL 376379 (Del. Ch. Apr. 4, 2000)	\$260.00	\$335.47	29%
<i>Gonsalves v. Straight Arrow Publishers, Inc.</i> , 2002 WL 31057465 (Del. Ch. Sept. 10, 2002)	\$100.00	\$262.96	163%
<i>Gentile v. SinglePoint Financial Inc.</i> , 2003 WL 1240504 (Del. Ch. Mar. 5, 2003)	\$2.46	\$5.51	124%
<i>Taylor v. American Specialty Retailing Group, Inc.</i> , 2003 WL 21753752 (Del Ch. July 25, 2003)	\$2,200.00	\$9,079.43	313%
<i>Union Illinois 1995 Investment Limited Partnership v. Union Financial Group Ltd.</i> , 847 A.2d 340 (Del Ch. 2003)	\$9.40	\$8.74	(7%)
<i>Cede & Co. v. JRC Acquisition Corp.</i> , 2004 WL 286963 (Del Ch. Feb. 10, 2004)	\$13.00	\$13.58	5%
<i>In re Emerging Communications, Inc. Shareholders Litigation</i> , 2004 WL 1305745 (Del. Ch. May 4, 2004)	\$10.25	\$38.05	271%
<i>Doft v. Travelocity.com Inc.</i> , 2004 WL 1152338 (Del. Ch. May 20, 2004)	\$28.00	\$30.43	9%
<i>Lane v. Cancer Treatment Centers of America, Inc.</i> , 2004 WL 1752847 (Del. Ch. July 30, 2004)	\$260.00	\$1,345.00	417%
<i>Cede & Co. v. MedPointe Healthcare, Inc.</i> , 2004 WL 2093967 (Del. Ch. Aug. 16, 2004)	\$20.44	\$24.45	20%
<i>Prescott Group Small Cap, L.P. v. Coleman Co.</i> , 2004 WL 2059515 (Del Ch. Sept. 8, 2004)	\$9.31	\$32.35	247%
<i>Gesoff v. IIC Industries Inc.</i> , 902 A.2d 1130 (Del. Ch. 2006),	\$10.50	\$14.30	36%
<i>In re PNB Holding Co. Shareholders Litigation</i> , 2006 WL 2403999 (Del. Ch. Aug. 18, 2006)	\$41.00	\$52.34	28%
<i>Crescent/Mach I Partnership, L.P. v. Turner</i> , 2007 WL 1342263 (Del. Ch. May 2, 2007)	\$25.00	\$32.31	29%
<i>Highfields Capital, Ltd. v. AXA Financial, Inc.</i> , 939 A.2d 34 (Del. Ch. 2007)	\$31.00	\$24.97	(19.5%)

This chart was obtained from Radin, *The Business Judgment Rule*, referenced at footnote 18.