Also Visit – LawCast.com
The Securities Law Network

November 10, 2015

Mergers And Acquisitions; Appraisal Rights

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

Unless they are a party to the transaction itself, such as in the case of a share-for-share exchange agreement, shareholders of a company in a merger transaction generally have what is referred to as "dissenters" or "appraisal rights." An appraisal right is the statutory right by shareholders that dissent to a particular transaction, to receive the fair value of their stock ownership. Generally such fair value may be determined in a judicial or court proceeding or by an independent valuation. Appraisal rights and valuations are the subject of extensive litigation in merger and acquisition transactions. As with all corporate law matters, the Delaware legislature and courts lead the way in setting standards and precedence.

Delaware Statutory Appraisal Rights

Although the details and appraisal rights process vary from state to state (often meaningfully), as with other state corporate law matters, Delaware is the leading statutory example and the Delaware Chancery Court is the leader in judicial precedence in this area of law. More than half of U.S. public companies and more than two-thirds of Fortune 500 companies are domiciled in Delaware.

Moreover, as is consistent with all states, the Delaware General Corporation Law ("DGCL") Section 262 providing for appraisal rights requires both petitioning stockholders and the company to comply with strict procedural requirements. The following is a high-level summary of the detailed procedures and process required by the company and stockholders where appraisal rights are available and where the stockholder desires to avail itself of such rights.

Except in share exchange transactions where all shareholders are a direct party to the transaction and transaction documents, stockholders of a corporation that is being acquired in a merger transaction have a statutory right to a court appraisal of the fair value of their shares. Dissenting stockholders may seek this judicial determination as an alternative to accepting the merger consideration being offered in the transaction negotiated by the company's board of directors.

Section 262 of the DGCL gives any stockholder of a Delaware corporation who (i) is the record holder of shares of stock on the date of making an appraisal rights demand, (ii) continuously holds such shares through the effective date of the merger, (iii) complies with the procedures set forth in Section 262, and (iv) has neither voted in favor of nor consented in writing to the merger, to seek an appraisal by the Court of Chancery of the fair value of their shares of stock.

Where an action allowing for appraisal rights is to be voted on by stockholders, the corporation must give written notice to its stockholders as of the meeting notice record date, not less than 20 days prior to the meeting. The written notice must include a copy of Section 262 of the DGCL. Each stockholder electing to demand appraisal rights for their shares must (i) deliver a written demand to the company for appraisal prior to the taking of the stockholder vote on the merger (or, in the case of a short-form merger or a merger approved by a written consent of stockholders, within 20 days of the mailing of a notice to stockholders informing them of the approval of the merger), (ii) file a petition with the Delaware Court of Chancery within 120 days after the effective date of the merger, and (iii) serve a copy of such petition on the corporation surviving the merger. Within 10 days of the effective date of the merger, the surviving corporation must give each stockholder that has elected appraisal rights, and not thereafter voted for or consented to the merger, notice of such merger effective date.

Where an action allowing for appraisal rights is approved without a vote by stockholders, within 10 days of the approval the corporation shall notify each of the stockholders who are entitled to appraisal rights of the approval of the merger and that appraisal rights are available. If already completed, the notice shall include the effective date of the merger. The written notice must include a copy of Section 262 of the DGCL. Each stockholder electing to demand appraisal rights for their shares must deliver a written demand to the company for appraisal within 20 days of the mailing of a notice to stockholders informing them of the approval of the merger. Thereafter the same procedures will apply as when approval was by a vote of stockholders.

At the hearing the court will determine the stockholders that have properly complied with the statute and are entitled to appraisal rights. Once it is determined which stockholders are entitled to an appraisal, the court will proceed with the substantive process of determining fair value. The statute requires that in determining such fair value, the court shall take into account all relevant factors (see the discussion below regarding the substantive fair value determinations).

Unless the court has good cause and determines otherwise, interest of 5% above the Federal Reserve discount rate shall accrue on the fair value of the shares from the date of the merger until the date paid. The court also has the statutory right to grant or deny the recovery of attorney's fees and costs to a petitioning shareholder. From and after the effective date of the merger, stockholders who have demanded appraisal rights are not entitled to vote their shares or to receive any dividends or other distributions (including the merger consideration) on account of these shares unless they properly withdraw their demand for appraisal.

Dependent on the consideration to be received, appraisal rights are not available for (i) shares of the corporation surviving the merger if the merger does not require the approval of the stockholders of such corporation and (ii) shares of any class or series that is listed on any national security exchange or held of record by more than 2,000 holders. In particular, these exceptions do not apply if the holders of such shares are required to accept in the merger any consideration other than (i) shares of stock of the corporation surviving or resulting from the merger or consolidation, (ii) shares of stock of any other corporation that will be listed on a national securities exchange or held of record by more than 2,000 holders, (iii) cash in lieu of fractional shares, or (iv) any combination of the

foregoing. In addition, these exceptions do not apply in respect of shares held by minority stockholders that are converted in a short-form parent subsidiary merger.

Section 262 of the DGCL also allows for a corporation to include in its certificate of incorporation the same merger appraisal rights for (i) amendments to the certificate of incorporation and (ii) the sale of all or substantially all of the assets of the corporation.

Determining Fair Value; The Longpath and Merion Capital Cases

On October 21, 2015, in Merion Capital LP v. BMC Software, Inc., the Delaware Court of Chancery rejected a dissenting shareholders effort to receive greater than the set merger price through the appraisal rights process. The Merion opinion is consistent with the June 30, 2015, Delaware Court of Chancery opinion which also rejected a dissenting shareholders effort to receive greater than the set merger price through the appraisal rights process. In Merion Capital and Longpath Capital, LLC v. Ramtron Int'l Corp., the Delaware court continued its recent consistent record of upholding the merger price as the most reliable indicator of fair value where the merger price was reached after a fair and adequate process in an arm's length transaction. In this case, the merger price followed several rejected bids, an active solicitation of other potential buyers, and a three-month hard bargaining process.

Generally there are four recurring valuation techniques used in an appraisal rights proceeding: (i) the discounted cash flow (DCF) analysis; (ii) a comparable company's analysis and review; (iii) a comparable transactions analysis and review and (iv) the merger price itself. Merger price is usually reached through the reality of a transaction process, as opposed to the academic and subjective valuation processes used in litigation challenging such price. Courts unanimously give greater, and usually 100%, weight to the merger price where the merger negotiation process was adequate.

Where there is a question as to the process resulting in the final merger price, Delaware courts generally look to the DCF analysis as the next best indicator of fair value. In this case, the court rejected the DCF analysis presented by the parties' experts in the litigation as based on unreliable management projections. Although a DCF analysis is often used in litigation to challenge the merger price, as with the Longpath case, the Delaware courts will not give much weight to a DCF model based on management-prepared projections where such projections are prepared outside the ordinary course of business such as in response to a hostile takeover bid, other potential transaction or for use in litigation.

Moreover, even where management projections are prepared in the ordinary course, the courts will consider the process used, assumptions made and the experience of management in preparing such projections as well as other qualitative and quantitative standards as to their reliability.

In addition to being skeptical regarding the weight to be given a DCF analysis, courts will likewise be skeptical regarding comparable transactions. In reviewing comparable transactions, courts will consider the types of companies involved, multiples used in each industry, and basic business realities.

Prior to the recent slew of cases upholding merger price as the best indication of value, the seminal case on appraisal rights was Weinberger v. UOP, 457 A.2d 701 (Del. 1983), which held that a proper valuation approach "must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court." The Weinberger court also held that the valuation should include elements of future value that are known or susceptible to proof, excluding only speculative elements. Following Weinberger the DCF model gained in popularity with the Delaware courts. As discussed above, recently the DCF model has been losing ground in favor of the merger price itself where the price is achieved following a fair and adequate process in an arm's length transaction.

Managing Risks Associated with Appraisal Rights

The best way to manage risks associated with the appraisal process, and all aspects of the merger itself, is to pay meticulous attention to the process. The board of directors should utilize legal and financial advisors and delve into information gathering, analytical and deliberative processes and the manner in which they are documented in order to ensure that a defensible record is produced. See also my blog related to directors' responsibilities in the merger process and the importance of the process itself, here.

Careful attention must be paid to the disclosure documents provided to stockholders related to the transaction. The document should include a thorough description of all relevant facts that support the fairness of the merger consideration. Relevant facts include, among other matters, historical operating results and future prospects, competitive and other risks, levels of liquidity and capital resources, internal and external indicia of value, efforts to explore strategic alternatives and the results thereof, opportunities for interested parties to submit competing acquisition proposals, and fairness opinions obtained from financial advisors and supporting analyses. Of course, as with all anti-fraud considerations, the document cannot misstate or omit material facts and information.

Hedging in Merger Transactions

There has been a recent dramatic increase in appraisal rights actions filed by shareholders that purchase shares after the record date of the relevant transaction. That is, it appears that a group of investors are hedging on merger transactions and utilizing the appraisal process as part of their hedging strategy. An interesting paper and analysis by the The Harvard Law School Forum on Corporate Governance and Financial Regulation entitled "Appraisal Arbitrage – Is There a Delaware Advantage" sets forth a well thought out theory as to why this investment strategy may be profitable to arbitrageurs. Here is a brief summary of the theory and for those interested in learning more about this theory, I encourage reading the entire paper.

First, Delaware allows shareholders to pursue appraisal rights even if they purchase shares after the record date for voting on the transaction. Investors can delay their investment decision until they have a better idea of valuation of the target. Moreover, by delaying the investment decision to as close as possible to the closing date, investors can minimize or even eliminate the risk that the deal will not close.

Second, many courts give preference to the DCF analysis valuation method. However, investment bankers advising on M&A deals tend to be more conservative. The paper points out that in a review of sample deals, nearly two-thirds of the time there was a differential between valuation used by investment bankers in providing fairness opinions to parties in an M&A transaction and fair values determined by the Delaware Courts. Investors have an opportunity to take advantage of this spread.

Third, the Delaware statute requires the court to determine a point estimate rather than a range of fair value. Accordingly, transactions completed at the low end of the DCF value range have a greater chance of a court determining that the fair value is higher, even if only by a few points.

Finally, the Delaware statutory rate for successful petitioner in an appraisal rights action is higher than the current yield on U.S. Treasury Bonds, thus creating a potential economic incentive for arbitrageurs.

Legal & Compliance, LLC
330 Clematis Street, West Palm Beach, FL 33401
Local: 561-514-0936 Toll-Free: 800-341-2681
LAnthony@LegalAndCompliance.com
www.LegalAndCompliance.com
www.SecuritiesLawBlog.com
www.LawCast.com

The Author

Attorney Laura Anthony
Founding Partner
Legal & Compliance, LLC
Corporate, Securities and Going Public Attorneys
LAnthony@LegalAndCompliance.com

Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

Contact Legal & Compliance, LLC. Inquiries of a technical nature are always encouraged. Follow me on Facebook, LinkedIn, YouTube, Google+, Pinterest and Twitter.

Download our mobile app at iTunes and Google Play.

Disclaimer

Legal & Compliance, LLC makes this general information available for educational purposes only. The information is general in nature and does not constitute legal advice. Furthermore, the use of this information, and the sending or receipt of this information, does not create or constitute an attorney-client relationship between us. Therefore, your communication with us via this information in any form will not be considered as privileged or confidential.

This information is not intended to be advertising, and Legal & Compliance, LLC does not desire to represent anyone desiring representation based upon viewing this information in a jurisdiction where this information fails to comply with all laws and ethical rules of that jurisdiction. This information may only be reproduced in its entirety (without modification) for the individual reader's personal and/or educational use and must include this notice.

© Legal & Compliance, LLC 2015