

Recent Delaware Appraisal Rights Developments Address Interest Rate Risk but Leave Certain Transactions Vulnerable on Deal Price

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In recent months, there have been a number of important developments relating to stockholder appraisal rights in Delaware. Appraisal rights are generally available to dissenting stockholders in all-cash or cash/stock mergers and entitle the dissenting stockholders to an appraisal of the fair value of their stock by the Delaware Court of Chancery. Stockholders seeking appraisal, including appraisal arbitrage funds that buy stock prior to a merger for the purpose of exercising appraisal rights, also receive interest at a statutory rate that accrues on the eventual fair value – even if fair value is determined to be no greater than the deal price – from the effective date of the merger to the date of payment. While amendments to the Delaware General Corporation Law (“DGCL”) mitigate some appraisal risk with respect to this interest accrual, recent case law highlights that buyers continue to face the prospect of potentially significant post-closing economic exposure in deals where appraisal rights are available. In light of this case law, it is possible that we will begin to see an increased focus by parties to M&A deals, and their lenders, on contractual provisions intended to limit this appraisal risk, especially in transactions that are most vulnerable to appraisal arbitrage claims.

Statutory Amendments to Appraisal Rights

The Delaware legislature recently amended the appraisal rights statute to allow buyers to significantly reduce the interest rate risk that accompanies M&A transactions. The amendment to DGCL Section 262(h), which applies to transactions consummated pursuant to agreements entered into on or after August 1, 2016, gives the surviving corporation the right to make a voluntary cash prepayment in an amount determined solely by the surviving corporation to stockholders exercising appraisal rights. Under the revised statute, assuming that such a prepayment is made, interest will only accrue on the sum of (i) the difference, if any, between the prepaid amount and the fair value as eventually determined by the Court of Chancery, and (ii) interest that accrued prior to the prepayment, unless paid at that time. In order to limit the accrual of interest, buyers are likely to elect to make prepayments, and lenders in highly-leveraged acquisition financings may begin to require that borrowers agree to do so.

In re: Appraisal of Dell Inc. and In re Appraisal of DFC Global Corp.

While the recent statutory amendment addresses interest rate accrual risk, two recent Delaware Court of Chancery opinions highlight the continued deal price risk to buyers in transactions vulnerable to appraisal rights claims. On May 31, 2016, the Court of Chancery held in an appraisal proceeding that the fair value of the common stock of Dell Inc. (“Dell”) was \$17.62 per share, approximately 26% higher than the \$13.96 per share paid by the acquirors (including Dell founder Michael Dell).¹ In reaching his decision, Vice Chancellor Laster stated that he did not give any weight to the deal price and used a discounted cash flow model exclusively to derive Dell’s fair value. Prior to the Dell case, the Court of Chancery had on a number of recent occasions found deal prices to be the most reliable indicator of a corporation’s fair

¹ *In re: Appraisal of Dell Inc.*, C.A. No. 9322-VCL (Del. Ch. May 31, 2016).

value.² Vice Chancellor Laster cited these cases but declined to follow them, in part because (i) none of those cases involved a management buyout (an “MBO”) and (ii) “all the cases either involved a more active pre-signing market check or the process was kicked off by an unsolicited third-party bid.”

Despite Vice Chancellor Laster’s view that Dell’s sale process “easily would sail through” under an enhanced scrutiny review if challenged under a breach of duty claim, the Court emphasized the difference between a breach of fiduciary duty case and appraisal proceedings, and identified several specific factors that contributed to the Court’s determination that the deal price was below fair value. First, the Court pointed to the limitations of leveraged buyout (“LBO”) pricing models typically used by financial sponsors in pricing deals because a financial sponsor requires target IRRs to satisfy its own investors and there are limits on the amount of leverage that a company can support and the sponsor can use to finance the deal. Second, the Court was concerned that there was a gap between the market’s perception of Dell—which involved a focus on short-term, quarter-by-quarter results, as to which Dell had repeatedly missed its own forecasts—and Dell’s operative reality, which involved a nearly \$14 billion investment as part of a two-year transformation that had not yet been fully realized but as to which its senior management was still generally optimistic. The Court noted that the optimal time to take a company private is before any significant long-term investments have started to pay off, and stated that appraisal proceedings should address this opportunistic timing (even though the Court also found that Michael Dell had not purposefully sought to take advantage of any opportunistic timing). Finally, the Court was concerned with the lack of competition from strategic buyers (although the Court elsewhere acknowledged that during the post-signing go-shop, large strategic buyers did not show serious interest in acquiring Dell).

The Court also expressed concerns with the post-signing phase of the transaction, despite the existence of a go-shop provision and the fact that Dell’s advisors reached out to 60 third parties during the go-shop period. The Court discussed problems “endemic to MBO go-shops” and referenced academic literature supporting the view that financial sponsors rarely submit topping bids against other financial sponsors.

While some assumed that the Dell analysis would be limited to MBOs, in *In re Appraisal of DFC Global Corp.*, Chancellor Bouchard also declined to accept the deal price as the most reliable indicator of fair value, despite the fact that the transaction at issue was arm’s-length and was subject to a robust pre-signing market check.³ In the appraisal proceeding, the Court held that the fair value of the common stock of DFC Global Corporation (“DFC”) was \$10.21 per share, compared to the \$9.50 per share deal price.

In *DFC Global*, the Court acknowledged that the deal price in an arm’s-length transaction that was subject to a robust market check is a strong indication of fair value and that the Court of Chancery previously has attributed 100% weight to the deal price in certain circumstances, but the Court added that providing so much deference to the deal price is only appropriate when market conditions leading to the transaction are conducive to achieving a fair price. In *DFC Global*, the transaction was negotiated and consummated during a period of regulatory turmoil, which the Court felt imposed uncertainty on DFC’s profitability and future viability. Due to this uncertainty, management repeatedly adjusted its financial projections downwards. Chancellor Bouchard noted that the buyer was interested in the transaction *because* of this uncertainty, as it was part of the buyer’s strategy to obtain assets with potential upside at a favorable price. The Court felt that these market factors called into question the reliability of the deal price as an

² See *Merion Capital LP v. BMC Software, Inc.*, 2015 WL 6164771 (Del. Ch. Oct. 21, 2015); *LongPath Capital, LLC v. Ramtron Int’l Corp.*, 2015 WL 4540443 (Del. Ch. June 30, 2015); *Merlin P’rs LP v. AutoInfo, Inc.*, 2015 WL 2069417 (Del. Ch. Apr. 30, 2015); *In re Appraisal of Ancestry.com, Inc.*, 2015 WL 399726 (Del. Ch. Jan. 30, 2015); *Huff Fund Inv. P’ship v. CKx, Inc.*, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013).

³ *In re Appraisal of DFC Global Corp.*, C.A. No. 10107-CB (Del. Ch. July 8, 2016).

indicator of intrinsic value. Additionally, as in *Dell*, the Court noted that the buyer's status as a financial sponsor "focused its attention on achieving a certain internal rate of return and on reaching a deal within its financing constraints, rather than on DFC's fair value."

Notably, unlike in *Dell*, Chancellor Bouchard did not completely disregard the deal price. Because of the robust pre-signing market check that involved reaching out to both financial sponsors and several possible strategic buyers, and because the transaction did not involve the potential conflicts of interest inherent in an MBO, the Court determined that it could use the deal price as one measure of fair value and decided to weigh equally a discounted cash flow valuation, a multiples-based valuation and the deal price.

Takeaways

It remains unclear how broadly the *Dell* and *DFC Global* opinions will be applied, although the *DFC Global* opinion clarifies that the risk from appraisal proceedings is not limited to MBOs. Notably, in each case the Court focused on transaction timing. In *Dell*, the company was still in the process of a transformation that had not yet begun to generate results; and, in *DFC Global*, the company faced regulatory uncertainty. It is possible that the courts may be more likely to find that the fair value deviates from the deal price when the company is being sold at a sub-optimal time. Of course, whether timing is optimal is ordinarily only clear with the benefit of hindsight.

Although the statutory amendment to DGCL Section 262(h) addresses interest rate risk, it does not help buyers manage the deal price risk associated with the exercise of appraisal rights (including risk related to appraisal arbitrage), which is a long-standing, unaddressed issue in Delaware public company transactions.⁴ Deal price risk should remain manageable in transactions with a robust sales process and without perceived timing vulnerability, which, combined with the statutory amendment to reduce interest rate risk, should provide buyers with greater overall price certainty for these categories of transactions. But in light of *Dell* and *DFC Global*, parties to transactions without an ability to have a robust sales process or transactions with sub-optimal timing are still vulnerable with respect to deal price risk and are lacking an ideal solution. As the chart attached as Appendix A demonstrates, the percentage of transactions that include appraisal closing conditions intended to manage deal price risk has remained relatively low and steady since 2008, in part because appraisal closing conditions, when set at a level useful to managing the exposure, have been viewed negatively because of their negative impact on deal certainty. However, given the recent case law, we can envision that parties to vulnerable M&A transactions, and their lenders, may seek to negotiate appraisal conditions to address the deal price risk associated with appraisal rights.

Finally, lenders in highly-leveraged acquisition financings may seek to require their borrowers to contractually agree to avail themselves of the DGCL Section 262(h) statutory prepayment option in order to limit the accrual of interest during any appraisal proceedings.

⁴ With respect to public company transactions, there is a strong case to be made that applicable fiduciary duties and standards of judicial review combined with a vigorous plaintiffs' bar provide stockholders with adequate protections without needing appraisal rights.

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Frequency of Appraisal Closing Conditions⁶

Year	Total Number of Announced Deals	Percent of Announced Deals with Appraisal Conditions	Percent of Announced Deals with Financial Buyers and Appraisal Conditions	Total Number of Announced MBOs	Percent of Announced MBOs with Appraisal Conditions
2008	99	9.1%	4.0%	1	100%
2009	99	9.1%	4.0%	2	50%
2010	194	9.8%	2.1%	3	33.3%
2011	169	4.1%	1.2%	1	0.0%
2012	166	5.4%	0.6%	4	0.0%
2013	205	10.7%	3.9%	9	44.4%
2014	220	7.3%	0.9%	1	100%
2015	343	9.0%	3.5%	28	35.7%
2016 (to date)	201	8.0%	0.5%	7	0.0%

⁶ Source: Deal Point Data as of August 17, 2016. Note that Deal Point Data statistics do not include appraisal rights conditions to a tender offer.