

VALUATION

Stockholder Appraisal Actions Present an Attractive Litigation-Based Strategy for Hedge Fund Managers

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Hedge fund managers are increasingly turning to a long-underused litigation-based mechanism to generate investment returns. That mechanism – the Delaware stockholder appraisal action – allows managers controlling shares in a company targeted for merger or consolidation to significantly increase the value of those shares through a pure litigation play.

In a guest article, Ben Quarmby and Hassan A. Shah, a partner and an associate, respectively, at MoloLamken, review how appraisal actions work and describe some recent results. The article then discusses the advantages of using appraisal over traditional stockholder litigation, as well as some recent legislative and judicial pushback. Finally, the authors consider the potential opportunity that shareholder appraisal actions present for hedge fund managers and other asset managers.

For additional insight from Quarmby, see “*Measures Hedge Fund Managers Can Implement to Maximize Protection of Their Trade Secrets*” (Dec. 6, 2012). For commentary from other MoloLamken practitioners, see “*FCPA Considerations for the Private Fund Industry: An Interview With Former Federal Prosecutor Justin Shur*” (May 23, 2014); “*How Private Fund Managers Can Manage FCPA Risks When Investing in Emerging Markets*” (Jan. 10, 2013); and “*Political Intelligence Firms and the STOCK Act: How Hedge Fund Managers Can Avoid Potential Pitfalls*” (Apr. 5, 2012).

How Appraisal Works

Section 262(a) of the Delaware appraisal statute allows a stockholder willing to temporarily forgo the consideration to which it is entitled following a merger to file an action seeking the fair value of its shares based on a judicial appraisal. The appraisal is a determination

of the acquired company’s fair value as if it had continued to operate as a standalone going concern.

The Delaware appraisal remedy is available to “[a]ny stockholder of a [Delaware] corporation” who:

- a. owns shares of stock on the date the stockholder demands an appraisal from the corporation;
- b. continues to hold the shares through the effective date of the merger or consolidation; and
- c. neither votes in favor of the merger or consolidation nor executes a written consent in favor of the transaction.^[1]

It is invoked in transactions where stockholders will be cashed out in a merger, and it may also be available in limited circumstances where the transaction consideration is stock.

Following the announcement of a merger, a stockholder must deliver a written demand for appraisal of the stockholder’s shares to the corporation. Once the merger has closed, the stockholder may then file an appraisal petition in the Delaware Court of Chancery, demanding that the court conduct an independent determination of the value of its shares. The stockholder then can seek targeted discovery about the corporation’s financial statements and business plans. If the matter proceeds to trial, competing experts provide evidence of the fair value of the petitioner’s shares.

Positive Results

Stockholder appraisal actions are not new. But they have become increasingly popular with hedge fund managers.

As a result, Delaware has seen a very significant uptick in the number of appraisal actions filed since 2012-2013.

Preliminary analyses of the stockholder appraisal market by leading academics suggest that the value of claims in appraisal in 2013 was approximately \$1.5 billion, “a tenfold increase from 2004 and nearly one percent of the equity value of all merger activity in 2013.”^[2]

That hedge fund managers should find appraisal actions attractive is no surprise; the potential upside can be significant. In an analysis of all post-trial decisions from 2010-2014, appraisal fair value determinations exceeded the merger price in all but two cases – with the awards representing premiums over the merger price ranging from 8.5% to 149% (with an average of 61%).^[3] By way of example:

- When Innovative Communications Corp. was bought by its majority-owned subsidiary, Emerging Communications, Inc., Greenlight Capital LLC was awarded a fair value decision of approximately 270% over the per share merger consideration of \$10.25 per share.
- After the closing of the leveraged buyout of American Commercial Lines, Inc., IQ Holdings sought an appraisal challenging the merger consideration of \$33.00 per share. Following a trial, IQ was awarded fair value of \$38.16 per share – an added value of more than 15% over the merger price.

In fact, given the potential for such returns, some asset managers have started to raise investment funds focused primarily or exclusively on employing the appraisal action as the method of implementing the funds’ investment strategies.

Advantages Over Traditional Stockholder Litigation

Stockholders have historically relied on derivative class action litigation to challenge mergers. The appraisal action, however, presents a number of advantages over traditional stockholder litigation.

An Investor Can Purchase a Claim

To bring an appraisal action, a stockholder need not hold the stock on the date the merger is first made public. An investor can purchase stock following the merger announcement but before the close of the merger and still be entitled to an appraisal.^[4] In a derivative action, by contrast, the putative plaintiff must already be a stockholder at the time of the alleged harm.^[5]

An Investor Has Greater Control Over an Appraisal Action

A classic breach of fiduciary duty derivative action proceeds as a class action, with plaintiffs’ counsel directing the litigation. That arrangement can interfere with (and even undermine) the actual goals of aggrieved stockholders.

By contrast, an appraisal action proceeds directly between the individual stockholder and the corporation, enabling the stockholder to exert far greater control and influence over the litigation.

Appraisal Is a Streamlined Remedy

Challenges based on pleading standards – both at the motion to dismiss and summary judgment stages – do not exist in appraisal actions. A petitioner is entitled to discovery that is relevant to the fair value determination and will have his day in court. The timeline for appraisal is therefore significantly streamlined relative to traditional civil litigation, and can quickly proceed from petition to a post-trial decision in 18-24 months.

Appraisal Offers Limited Downside

The merger price generally acts as a floor on the fair value decision. Even if a court only awards the merger price as fair value, a stockholder is also entitled to interest on that determination. The statutory interest rate is 5% over the discount rate, which is relatively plaintiff-friendly in the current low interest rate environment. Moreover, to the extent a stockholder has financed a portion of its shares, it can achieve a levered return on equity in excess of the statutory interest rate.

Of course, there are limitations to the appraisal action. It is customarily employed when the consideration is cash. It would not apply when the consideration is entirely publicly traded stock (the “market-out exception” under 8 Del. C. § 262(b)(1)), which is a favored currency of strategic purchasers. It also requires that the plaintiff control enough shares at the outset to justify the litigation costs associated with the challenge. And, as is the case with any litigation, ultimate outcomes and timing can never be guaranteed. However, as the examples above show, the mechanism has already proven to be worthwhile for many investors, including hedge fund managers.

Recent Pushback

Recently, there has been some degree of backlash against appraisal actions. The Delaware legislature and courts have both shown interest in limiting their scope.

Proposed Legislative Amendments

The Delaware General Assembly, for example, considered proposed amendments to the appraisal statute that would have imposed significant limitations. Under the proposed amendments, a stockholder would have been able to seek appraisal only if: (1) the total number of shares entitled to appraisal exceeded one percent of the outstanding shares that could have sought appraisal; (2) the value of the merger consideration for the total number of shares entitled to appraisal exceeded \$1 million; or (3) the merger was a parent-subsiary merger.

The proposed amendments also would have permitted a corporation to cut off the accrual of interest by paying the stockholder an amount chosen by the corporation (presumably the merger consideration). The stockholder would then only be entitled to interest on the difference between the amount previously paid by the corporation and the eventual fair value determined by the court.

While the amendments were not adopted in 2015, similar legislative efforts continue.

Judicial Limitations

Courts have pushed back as well. In some recent appraisal cases, the Court of Chancery has invoked the merger price as the best measure of fair value. Factors that courts consider when they have relied on the merger price include (1) whether the target corporation engaged in a broad market auction; (2) whether the transaction process was free of decisional conflicts; and (3) whether deal protections designed to discourage topping bids were employed.^[6]

Also, while the merger price has generally served as a floor for fair value, there is now some indication that the court may be more receptive to awarding fair value below the merger price (generally in a case involving a strategic acquirer where synergies are removed from the fair value determination).^[7]

Potential Opportunities

Despite these recent trends, the opportunity that appraisal actions presents for stockholders and hedge fund managers remains immense. The mergers and acquisitions market is forecast to remain “powerful” according to Wall Street.^[8] Investment returns generated by deploying stockholder appraisal actions can also be significantly greater than those achieved through traditional investment strategies, particularly in light of recent stock market performance. Even with the recent legislative and judicial pushback, a stockholder’s downside remains quite limited. Finally, appraisal remains attractive due to its straightforward procedure, as compared to traditional litigation. The timeline to a decision thus makes such actions more tenable for investors with constrained litigation budgets and investment horizons.

As it stands, the stockholder appraisal landscape is therefore one of tremendous opportunity. In the right case, an investor surveying merger arbitrage can analyze a proposed deal following a merger announcement, acquire the necessary stock, retain counsel, trigger litigation and obtain a judgment – all within the space of 18-24 months – in many successful cases obtaining double-digit returns with limited downside.

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[1] See 8 Del. C. § 262(a).

[2] Charles R. Korsmo and Minor Myers, Appraisal Arbitrage and the Future of Public Company M&A, 92 Wash. U. L. Rev. 1551, 1553 (2015).

[3] Philip Richter, et al., Why Delaware Appraisal Awards Exceed the Merger Price, Harvard Law School Forum on Corporate Governance and Financial Regulation (Sep. 23, 2014).

[4] In re Appraisal of Transkaryotic Therapies, Inc., C.A. No. 1554-CC (Del. Ch. May 2, 2007).

[5] 8 Del. C. § 327.

[6] See, e.g., Merion Capital LP v. BMC Software, Inc., C.A. No. 8900-VCG (Del. Ch. Oct. 21, 2015) (fair value was merger price); Merlin Partners LP v. AutoInfo, Inc., C.A. No. 8509-VCN (Del. Ch. Apr. 30, 2015) (same); Huff Fund Inv. P'ship v. CKx, Inc., C. A. No. 6844-VCG (Del. Ch. Nov. 1, 2013) (same); In re Appraisal of Ancestry.com, Inc., Cons. C.A. No. 8173-VCG (Del. Ch. Jan. 30, 2015) (same).

[7] See, e.g., LongPath Capital, LLC v. Ramtron Int'l Corp., C.A. No. 8094-VCP (Del. Ch. Jun. 30, 2015) (fair value of \$3.07 per share compared to merger price of \$3.10 per share).

[8] Dana Mattioli, Big Banks: Pace of M&A Deals Will Still Be Strong in 2016, The Wall Street Journal (Jan. 20, 2016).