Roberta Romano, Note on Appraisal Arbitrage

In recent years, there has been an increase in the number of appraisal actions filed in the Court of Chancery, from a handful in the early 2000s to over 20 a year more recently, an amount close to one-quarter of all transactions where appraisal is possible. See Wei Jiang, Tao Li, Danqing Mei and Randall Thomas, "Reforming the Delaware Appraisal Statute to Address Appraisal Arbitrage: Will it be Successful?" (April 2016). A major factor appears to be the emergence of appraisal arbitrageurs, hedge funds that purchase shares in merger targets in order to file an appraisal action. Merion Capital, the petitioner in *BMC Software*, is one of the more active of those funds. Jiang et al. report that hedge funds dominate the cases as petitioners, with seven hedge funds appearing in half of the cases and accounting for over half of the dollar volume. What has attracted hedge funds into this activity, or to put it another way, why has this form of arbitrage emerged in recent years?

First, in a series of decisions, the Chancery Court has permitted appraisal actions to be brought by individuals who did not hold shares at the time of the record date and therefore could not have voted against the transaction (despite that statutory requirement for standing). The Court rejected the contention (of the respondent corporation) that a shareholder seeking appraisal must show that its specific shares voted against the merger to meet the statutory requirement. Rather, it held that as long as the number of shares seeking appraisal was less than or equal to the number of shares that were voted against the merger by the shareholder of record (the Depository Trust Corporation), the the action could be brought. *In re Appraisal of Transkaryotic Therapies, Inc.*, No. CIV.A. 1554-CC (Del. Ch..May 2, 2007). The Court based its holding on the plain language of the appraisal statute, that provides appraisal rights to the "holder of record." The depository had, indeed, voted shares against the merger and perfected the appraisal rights of the petitioning shares (of course it is simply a nominal petitioner, perfecting the rights at the request of the beneficial owner). In short, the actions of the beneficial owner are simply of no import– as the court put it they are "irrelevant in appraisal matters." Note that a tracing rule, as advocated by the respondent regarding votes cast by the prior owners of the post-record-date beneficial owners' shares, would be impossible to meet, given modern trading practices, in which shares are held in street name and the specific buyer and seller of shares in any single transaction are not matched).

The *Transkaryotic* approach is advantageous for arbitrageurs because they can wait to buy shares and bring appraisal actions until after information regarding the transaction is revealed that can provide a better understanding of both the value of the target and the risk of a deal not closing, information that increases the probability of bringing a profitable appraisal action (i.e., making an investment in the target's shares worthwhile). For example, the definitive proxy statement for a merger, which contains such information, will be filed after the announcement of the deal and after the record date has passed. Merion Capital bought its BMC shares in July 2013 in the interval between the filing of the definitive proxy and the shareholder meeting date.

We can characterize the ability of an investor to delay the purchase of stock in a target and still bring an appraisal action as providing the investor with an option; the investor can minimize its risk (the merger does not close) and maximize its return (more information about value, increasing the probability of choosing to bring an action that will be successful) by waiting as long as possible to buy the shares (recall the positive impact on a call option's value of the time to exercise). Jetley and Ji contend that this option is not priced, a factor that increases the incentive to engage in appraisal arbitrage. Gaurav Jetley and Zinyu Ji, "Appraisal Arbitrage—Is There a Delaware Advantage?," 71 Business Lawyer 427 (2016). Their reasoning is that the target shareholders who will sell to the arbitrageur are happy with the deal price, and are anxious to obtain that price immediately rather than wait for the transaction to close, and therefore will not incorporate into the sale price the value of being able to bring an appraisal action for a possibly higher price in the future. Jetley and Ji also note that the statute provides appraisal arbitrageurs with a put option (apart from the Court's having created a call option), by providing dissenting shareholders with 60 days after the merger closing date to decide not to file an appraisal action and to sell the shares to the acquirer at the transaction price (i.e., to exercise a "put").

Second, in an appraisal action, the petitioner-shareholder is awarded interest, fixed at a statutory rate, on the appraised value of the shares from the date of the merger's close to the date of the judgment in the appraisal action. The interest is awarded whether or not the appraised value exceeds the merger price. The statutory interest rate is 5 percent above the risk-free rate. (This rate was established in 2007, before the risk-free rate was close to zero as it has been since the onset shortly thereafter of the global financial crisis, in order to end what had been a

considerable piece of appraisal actions, litigation over the appropriate interest rate.) Accordingly, a hedge fund does not need to be awarded a substantial premium over the merger price for the appraisal action to be profitable. (One cannot obtain a comparable 5% yield on a risk-free investment or even a risky corporate bond these days. See Jetley and Ji, supra, for a comparison to the return on 3-year instruments, which is the average duration of an appraisal proceeding in recent years).

Indeed, Jiang, et al. estimate that the interest rate is responsible for a 45% percent increase in petitions filed in recent years, and the effect is especially true for cases whose petitioners hold large stakes. Another way they put the estimated effect is that: "for every percentage point increase in the yield that arbitrageurs obtain in excess to their alternative risk free investment (e.g., treasury bills with comparable duration), the probability of an appraisal filing increases by about 1.3 percentage points." More important, in analyzing the returns in those cases in which they are reported–many cases are settled with terms not publicly disclosed–they find that the average return from interest accrual at 76.8% is considerably higher than the average improvement in price. In fact, if there were no interest award, 11% of the cases would have resulted in a negative return (and these figures do not include litigation costs, which are unavailable, although practitioners suggest they are in the range of several million dollars). Overall, they conclude that "a majority (60.5%) of the returns to appraisal arbitrage in trial cases came from interest accrual rather than higher valuation awarded by the court."

The proliferation of appraisal arbitrage cases was adversely viewed by the corporate bar (and of course the merging parties), who perceive the phenomenon as an exercise in interest rate arbitrage and not genuine valuation disagreement (consistent with the findings of Jiang et al). These concerns led to discussions seeking a legislative solution in the Council of the Corporate Law Section of the Delaware State Bar, which is the body that proposes all corporation code revisions to the Delaware legislature. After failing to recommend any changes in 2015, the Council presented, and the legislature enacted, amendments to the statute, effective August 1, 2016, directed at reducing appraisal arbitrage. While no action was taken with respect to the issue regarding the eligibility of shareholders to file despite purchasing shares after the record date, the statutory resolution did address the interest rate issue. A new clause in subsection (h) of section 262 permits companies, at any time before the entry of judgment in the appraisal action, to pay a

cash amount (of the company's choice) to all of the shareholder-petitioners entitled to appraisal, whereupon interest will accrue only on the difference between the Court's final appraised value and the amount paid (and any interest accrued prior to the cash payment that was not also paid at that time) . This interest reduction amendment overturned a ruling by the Chancery Court that had rejected such an approach.

Although the 2016 amendments, according to the analysis in the Jiang et al. study, should reduce appraisal arbitrage, commentators have expressed the view that the decision to take advantage of the statute is not clear-cut. One concern is that a payment up front (to reduce the interest accrual) provides resources to petitioners, reducing the cost of bringing an appraisal action (directly or indirectly by not having funds tied up for the several years that such litigation averages). In addition, the greatest benefit of the statute accrues to the earliest prepayment (i.e., when the petition is filed), but that timing would tend to be before a company retained a valuation expert or an expert's work was completed, and would thus work at cross purposes if the amount prepaid were to be more than the expert's valuation. For a brief discussion of these and other concerns, see "Companies Face Tough Decision Under Delaware's New Appraisal Law," 31 *BNA's Corporate Counsel Weekly* 233 (August 3, 2016).

The recent appraisal opinions, discussed in "Note on Reliance on Merger Price in Delaware Appraisal Cases" (CM pp. 278-85), that have held both merger and pre-deal ("unaffected") stock prices to be the fair value are more likely to put a halt to appraisal arbitrage than the statutory amendments. These decisions make it no longer a sure bet that the appraised value will be at least equal to the deal price, which is the typical outcome when the court relies on DCF valuations, and thereby increase the risk (and reduce the profitability) of the strategy. As one article put it, comparing the strategy before and after the decisions in *DFC, SWS,* and *ACP Masters* (all cases whose stockholder-petitioners were hedge funds engaging in that strategy)*:*

> "[P]rior to recent developments, the appraisal arbitrage strategy resembled buying a lottery ticket with a guaranteed minimum payout equal to the purchase price plus interest... [But following those decisions], [m]ost appraisal arbitrage will come down to a bet on whether the company will settle quickly for a modest premium to avoid the expense and delay of litigation."

Gardner Davis and John Wolfel, "The Changing Landscape of Delaware Appraisal Rights," *Bloomberg Law Insights*, (Nov. 20, 2017).