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Amendments to DGCL Limit Appraisal Proceedings

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In recent years, there has been a notable rise in the number of appraisal proceedings initiated in response to merger transactions. Appraisal proceedings provide stockholders dissenting from a merger the right to forego the merger consideration in certain circumstances and instead receive a judicial determination of the fair value of their shares.

Much debate has surrounded this increasing frequency with which stockholders are seeking appraisal. As compared to traditional fiduciary duty claims challenging merger transactions, appraisal proceedings tend to go to trial more often, thus significantly increasing the time and expense involved for the respondent corporation. In response to such debate, the Corporation Law Council of the Delaware State Bar Association conducted a two-year study of the issues involved and proposed amendments to Delaware's appraisal statute imposing certain limits on stockholders' rights relating to appraisal proceedings. The amendments to Section 262 of the Delaware General Corporation Law (the DGCL) provide a de minimis threshold on the right to bring an appraisal proceeding involving shares traded on a national securities exchange, subject to certain exceptions. The amendments also allow a respondent corporation to cut off the accrual of interest, at least in part, in an appraisal proceeding by paying an amount to stockholders at any time prior to final judgment. Such amendments, described in more detail below, were passed by the Delaware legislature and recently became effective for merger and other transaction agreements entered into on or after Aug. 1.

The Recent Rise of Appraisal Proceedings

A recent study found that from 2004 through 2010, there was an average of approximately nine appraisal proceedings initiated per year. By contrast, the average number more than doubled during the period of 2011 to 2014 to an average of approximately 22 complaints filed per year, as in *Charles Korsmo & Minor Myers, Reforming Modern Appraisal Litigation*, 41 Del. J. Corp. L. (forthcoming 2016) (manuscript at 15). This represents a significant shift in the method by which stockholders challenge M&A transactions, which traditionally has focused on fiduciary duty claims.

Commentators have suggested a number of potential causes for this change. The increased use of "appraisal arbitrage" by hedge

funds and other market participants has been cited as a potential cause. Arguably, the statutorily defined interest rate presents a favorable opportunity for some to earn above-market returns, encouraging them to seek appraisal. In addition, recent appraisal cases resulting in a judicial determination of fair value far in excess of the merger consideration could be partially responsible for this phenomenon. While important to note that the DGCL amendments were proposed in recognition of the recent trends in appraisal activity, the purpose of this article is to shed light on how the amendments will affect appraisal proceedings rather than to comment on the underlying justification for the amendments.

The De Minimis Threshold

As amended, DGCL Section 262(g) limits the availability of an appraisal proceeding for shares traded on a national securities exchange. In such a case, the appraisal proceeding must be dismissed by the court unless any of the following requirements are met: the total number of shares for which appraisal rights have been perfected exceeds 1 percent of the outstanding shares of the class or series that could have sought appraisal; the value of the consideration provided in the merger or consolidation for such total number of shares for which appraisal rights have been perfected exceeds $1 million; or the merger was approved without a stockholder vote pursuant to Section 253 or 267, i.e., a "short-form" merger.

Accordingly, the appraisal proceeding will be dismissed unless the merger in question is a short-form merger, or the shares entitled to appraisal, either in number or in value, are significant enough to justify the time and expense of litigation. Academic research has indicated that defending an appraisal proceeding can cost an estimated $3 million to $5 million, on average, according to "Reforming the Delaware Appraisal Statute to Address Appraisal Arbitrage: Will It Be Successful?" by Wei Jiang, Tao Li, Danqing Mei & Randall S. Thomas (Columbia Bus. Sch., Research Paper No. 16-31; Vanderbilt L. & Econ., Research Paper No. 16-11, April 20). Moreover, a recent study estimated that, on average, there are over 800 days from the merger effective time until the court renders a decision in the appraisal proceeding. The fact that appraisal cases are "unusually likely to go to trial," especially when compared with the "extraordinarily rare" incidence of trial for fiduciary duty claims, compounds the significant resources a respondent corporation must expend in the face of an appraisal petition.

Notably, the de minimis threshold does not foreclose stockholders owning a small number of shares from seeking appraisal because the threshold is measured by the aggregate shareholdings of all stockholders who have perfected their appraisal rights rather than the individual holdings of any such dissenting stockholder. As such, appraisal proceedings will not be reserved exclusively for those stockholders with significant holdings and resources sufficient to bring the proceeding in the first instance. At the same time, the de minimis threshold will minimize the risk that appraisal will be used solely to achieve a settlement because of the nuisance value of discovery.

With regard to short-form mergers under Sections 253 or 267, minority stockholders receive no advance notice of the merger, their directors do not consider or approve it, and there is no stockholder vote. Accordingly, appraisal may be the only remedy available for a dissenting stockholder in a short-form merger. Hence, the de minimis limitation does not apply to short-form mergers. The de minimis threshold also does not apply to corporations whose shares are not traded on a national

securities exchange as a result of the difficulty in valuing the stock of such a corporation.

Corporation's Option to Limit Accrual of Interest

Prior to the effectiveness of the 2016 amendments, absent good cause shown (i.e., bad-faith assertion of valuation claims), Section 262(h) required the respondent corporation to pay interest in appraisal proceedings on the entire amount determined to be fair value, calculated from the effective time of the merger through the date of payment of the judgment at a rate of 5 percent over the Federal Reserve discount rate, compounded quarterly. (See "Appraisal Arbitrage—Is There a Delaware Advantage?" by Gaurav Jetley and Xinyu Ji, 71 BUS. LAW. 452 (Spring 2016).) Commentators have noted that, in recent years, this interest rate has "far exceeded" what could be earned from fixed-income investments with similar duration and risk levels.

Studies reveal that "a majority" of the returns in many appraisal proceedings that went to trial from 2000 to 2014 came from interest accrual rather than a higher valuation awarded by the court, although some more recent cases have resulted in a different outcome. Absent these recent cases, this suggests that some appraisal petitions may have been motivated, at least in part, by a desire to receive above-market interest returns, particularly in light of the significant amount of time between the merger effective time and the date of payment, as discussed above.

As a result, the amendment to Section 262(h) was designed to permit corporations to cut off the statutory accrual of interest on at least a portion of any amount ultimately awarded by the court. As amended, the statute gives respondent corporations the option to pay stockholders seeking appraisal a sum of money toward the "fair value" of the shares, the amount of which is determined in the corporation's sole discretion, at any time before judgment is entered in the appraisal proceeding. Following such payment, interest only accrues on the sum of the excess, if any, of the fair value of the shares, as determined by the court in the proceeding, over the amount pre-paid by the corporation, and interest accrued from the merger effective time until the date of the pre-payment, unless such interest was paid at the time of the pre-payment. Notably, there is no requirement or inference that the amount paid by the corporation has any bearing on the fair value of the shares to be appraised.

Conclusion

Time will reveal whether the amendments to Section 262 will serve their intended purposes of minimizing the effects of "nuisance" litigation with limited value and decreasing the burden of interest payments on corporations. It is unclear whether corporations will exercise their right to make a pre-payment of some amount pursuant to Section 262(h) in order to cut off the accrual of interest, but the right to do so is available should they desire to exercise it. Certainly, appraisal proceedings will continue to be brought under amended Section 262, though claimants will need to hold the minimum threshold (in the aggregate) in order to pursue the appraisal proceeding.

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