

# The Rise and (Apparent) Fall of the Top-Up Option "Appraisal Dilution" Claim

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"Top-Up" option provisions have become a popular feature in two-step mergers over the past several years. Indeed, in one recent decision, the Delaware Court of Chancery described them as "commonplace."<sup>1</sup> Typically, these provisions entitle a buyer to acquire authorized and unissued shares of the target's stock for the same purchase price as the tender offer price, and are usually exercisable only if a certain "minimum threshold" number of shares tender into the offer. The acquisition of these additional shares permits the buyer to obtain 90% of the target's stock so that a "second-step" merger can be completed more quickly as a short form merger under 8 *Del. C.* § 253, rather than as a long-form merger under 8 *Del. C.* § 251. At their core, Top-Up options are designed to get a transaction done sooner, and "get money into the hands of stockholders faster."<sup>2</sup>

Prior to 2010, there was a dearth of Delaware authority addressing Top-Up option provisions. The few Delaware cases that addressed the issue appeared to suggest that Top-Up options, standing alone, were not improper.<sup>3</sup> However, some commentators suggested that they could potentially result in the dilution of a company's value in connection with any appraisal proceeding associated with the short-form merger (the so-called "appraisal dilution" claim).<sup>4</sup> The thrust behind this argument is the concern that Top-Up options allegedly coerce

shareholders to tender their shares to avoid the risk that the issuance of a large number of shares pursuant to the Top-Up option, for less than fair value (usually in the form of a promissory note with a low interest rate),<sup>5</sup> would dilute remaining stockholders' interests in the corporation and restrict their ability to obtain fair value for their shares as part of an appraisal action.<sup>6</sup>

Not surprisingly, as the deal market began to pick back up in 2010, and many deals were structured as two-step mergers with Top-Up option provisions, a host of plaintiff shareholder suits were filed, raising appraisal dilution claims with the Top-Up option provisions squarely in their sights. This renewed focus on Top-Up option provisions afforded the Delaware Court of Chancery an opportunity to weigh in on these provisions with regularity throughout the year.

For example, in *Olson v. EV3, Inc.*, Vice Chancellor Laster permitted limited expedited discovery surrounding the possible dilutive and coercive effects of Top-Up options. As a primary matter, Plaintiffs in this case claimed that the Top-Up option was impermissibly coercive and dilutive to appraisal rights. Plaintiffs also argued that the EV3, Inc. board failed to satisfy its obligations under 8 *Del. C.* §§ 152, 153, and 157, which generally provide boards of directors the ability to set the consideration for the issuance of stock and to direct and implement the formation and issuance of an option. The Court granted expedition, noting that "[t]he potential coerciveness of these options, and the potential validity...is of significant import."<sup>7</sup> The Court explained:

It is an intellectually interesting argument as to whether...this deal structure is coercive. The Top-Up Option is designed, as [the parties all] recognize[], to get money into the hands of the stockholders faster. But there also is this potential unintended consequence—because I don't think it's an intended consequence to dilute down appraisal rights, but there is this potential unintended consequence on the appraisal process, and that's what the plaintiffs have focused on here, and that's something that hasn't, as I say, been definitively addressed.<sup>8</sup>

Thus, the Court ordered expedited discovery and set a date for a preliminary injunction hearing, holding “the coercion argument, and the suggestion that there are things about the Top-Up Option that should be disclosed, even in some type of contingent fashion, are ones that do give rise to a basis to claim for irreparable harm, and, hence merit the scheduling of a preliminary injunction hearing.”<sup>9</sup>

Significantly, however, the Court also noted in *EV3* that “the easy and obvious solution [to the appraisal dilution issue] is that these shares and the note just don’t get counted in terms of the appraisal proceeding.”<sup>10</sup> Picking up on this cue, deal makers responded to the Court’s concerns regarding appraisal dilution by including express language in merger agreements that would exclude shares issued in connection with a Top-Up option from any appraisal calculation. For example, the merger agreement pursuant to which ICX Technologies, Inc. agreed to be acquired by FLIR Systems, Inc. provided that:

The parties agree and acknowledge that in any appraisal proceeding with respect to the Dissenting Shares and to the fullest extent permitted by applicable Law, the fair value of the Dissenting Shares shall be determined in accordance with Section 262(h) of the DGCL without regard to the Top-Up Option, the Top-Up Shares or any consideration paid or delivered by Merger Sub to the Company in payment for the Top-Up Shares.<sup>11</sup>

The Court of Chancery’s reaction to this preemptive strike against the appraisal dilution claim was well-received. In a subsequent lawsuit challenging the ICX/FLIR merger agreement—including, most notably, a challenge to the Top-Up option provision—the Court forcefully denied a motion to expedite discovery and cast significant doubt on the validity of the appraisal dilution claim. In *ICX Technologies, Inc. Shareholder Litigation*, Vice Chancellor Laster noted that appraisal dilution claims surrounding the use of top-up options in the ICX deal were “nonexistent” because “the defendants undertook [upfront] clearly and explicitly [in the merger agreement] that they would not include the top-up shares of

the related consideration in the calculation of fair value for the purposes of any appraisal action.”<sup>12</sup> The Court went on to express the view that parties could, under Delaware law, expressly provide in the merger agreement that top-up options may be excluded from any appraisal calculation.<sup>13</sup> The Court based its rationale that parties may decide what shares to include, and what shares to exclude (*i.e.*, the Top-Up shares) in part on two older Delaware cases—*Gholl v. eMachines*<sup>14</sup> and *In re Sunbelt Beverage Corporation Shareholders Litigation*.<sup>15</sup> In *Gholl*, a case where the underlying transaction involved Top-Up options, Vice Chancellor Parsons went forward using an agreed-upon number of shares in an appraisal case. Though *In re Sunbelt* did not involve Top-Up options, Chancellor Chandler permitted the parties there to agree to set the number of shares for appraisal purposes.

Additionally, Vice Chancellor Laster expressly distinguished his ruling in *ICX* from his earlier comments in *EV3*, noting that “this is not a case like *EV3*. *EV3* was a situation where there were legitimate concerns about the validity of the Top-Up provision and the validity of the Top-Up shares. And given all that uncertainty, it made sense to expedite [there] and to also expedite coercion claims, which were based in part on the related uncertainty. Here, no one is making *EV3*-type validity claims, nor do I think they would make sense if they were asserted.”<sup>16</sup> Ultimately, *ICX* presented a “pure type top-up challenge” where defendants resolved the issue by making the commitment not to include the effect of the Top-Up option, if invoked, in the appraisal calculation.<sup>17</sup> Thus, “in the context of [the ICX] deal, the top-up is solely serving the function of getting money into stockholders’ hands faster.”<sup>18</sup> Indeed, the Vice Chancellor concluded that Plaintiffs’ appraisal dilution theory in *ICX* was so without merit that it would not even support a settlement if the parties had managed to resolve it.<sup>19</sup>

Shortly thereafter, Vice Chancellor Parsons had the opportunity to address Top-Up options claims in *In re Cogent Inc. Shareholders Litigation*. In that case, the Court rejected shareholder plaintiffs’ challenges to the proposed merger between Cogent, Inc. and 3M Company, and, in doing

so, appeared to reinforce the validity of Top-Up options.<sup>20</sup> Specifically, the Court again dismissed appraisal dilution claims where the merger agreement expressly excluded the Top-Up option from the appraisal calculation, and found that:

While the issue of whether DGCL § 262 allows parties to define the conditions under which appraisal will take place has not been decided conclusively, there are indications from the Court of Chancery that it is permissible. The analysis in the cited decisions indicates there is a strong argument in favor of the parties' ability to stipulate to certain conditions under which appraisal will be conducted—certainly to the extent that it would benefit dissenting stockholders and not be inconsistent with the purpose of the status. In this case, I find that § 2.2(c) of the Merger Agreement, which states that "the fair value of the Appraisal Shares shall be determined in accordance with Section 262 without regard to the Top-Up Option...or any promissory note," is sufficient to overcome Plaintiffs' professed concerns about protecting the Company's stockholders from the potential dilutive effects of the Top-Up Option. Accordingly, I find that Plaintiffs have not shown that they are likely to succeed on the merits of their claims based on the Top-Up Option.<sup>21</sup>

Vice Chancellor Parsons also rejected plaintiffs' other attacks on the Top-Up options as not worthy of an injunction. Plaintiffs argued—like the plaintiffs in *EV3*—that defendants breached their statutory obligations under 8 *Del. C.* §§ 152, 153, and 157 to make an informed judgment regarding whether to grant the Top-Up option. However, the Court found that the record amply refuted this assertion.<sup>22</sup> Plaintiffs also claimed that the Top-Up option would allow 3M to take control of the company against the wishes of the company's minority shareholders, even if a majority of shares were not tendered in the deal. The Court concluded that "[w]hile Plaintiffs appear to be correct that it technically might be possible for 3M to acquire the Company through the Top-Up Option without acquiring a majority of the shares in the tender offer, this argument depends on the occurrence of more than one highly unlikely event

and is far too speculative to warrant injunctive relief."<sup>23</sup> The Court also determined that Plaintiffs' claim (similar to the claim in *EV3*) that the Top-Up option was essentially a "sham" transaction because 3M was funding the Top-Up shares via a promissory note that would subsequently be canceled was without merit. The Court found that "while it may be true that this obligation likely will be nullified if the two-step transaction closes, this does not change the fact that, giving due respect to the corporate form, when the note is issued, it will be a legally enforceable obligation owed by [the acquirers] to Cogent."<sup>24</sup>

Subsequently, the Court of Chancery refused to certify its decision in *Cogent* concerning the Top-Up option claim for interlocutory appeal, stating that "I conclude that the Opinion does not involve such exceptional circumstances that the challenged ruling can be said to have determined a substantial issue, established a legal right," or satisfied any of the other criteria sufficient to warrant interlocutory appeal.<sup>25</sup> The Court reiterated that the Top-Up option at issue in the case "presents little risk of any undue stockholder coercion."<sup>26</sup> The Delaware Supreme Court also refused to accept plaintiffs' application for interlocutory appeal.<sup>27</sup>

Thus, after *ICX* and *Cogent*, deal makers were left with an apparent blueprint for nullifying appraisal dilution and coercion claims associated with the use of Top-Up options. Thereafter, in approving a settlement in *In re Protection One, Inc. Shareholders Litigation*,<sup>28</sup> Vice Chancellor Strine expressed a view that perhaps takes things one step further. In that case, Vice Chancellor Strine appears to suggest that the claim of appraisal dilution is illusory, because Top-Up options are part of the accomplishment of the merger, as the "the top-up option is designed essentially to effectuate the completion of the transaction."<sup>29</sup> Under 8 *Del. C.* § 262, the Court's determination of fair value for appraisal purposes must clearly exclude the value arising from the accomplishment of the merger. To this end, Vice Chancellor Strine noted that "I would never think that in [anyone's] wildest dreams...that you would reduce the value of any award to an appraisal petitioner because of a

top-up option included in the merger agreement that gave rise to the appraisal triggering event.”<sup>30</sup>

Thus, it appears that the Court of Chancery is largely unconvinced that appraisal dilution and coercion claims relating to Top-Up options have merit—at least when merger parties expressly agree to exclude the Top-Up provision, shares issued under that provision, and any consideration from the acquiror for the Top-Up shares from any appraisal calculation.<sup>31</sup> There is even a strong indication that at least one member of the Court of Chancery thinks these issues would have no effect whatsoever on an appraisal proceeding because the Top-Up option provision, if invoked, would be considered a part of the accomplishment of the merger for appraisal purposes. Given the Court of Chancery’s strong guidance on this area, deal makers are likely to continue to include Top-Up options in tender offer deals.

Understandably, plaintiff stockholders will regroup, and likely develop new challenges. In that vein, Vice Chancellor Parsons rightfully noted in his opinion in *Cogent* declining to certify the case for appeal that the Delaware courts have not reached a “final conclusion about whether the challenged Top-Up Option is valid,” but found that he had “ample guidance” to support his conclusion that plaintiffs were not likely to be able to show the Cogent board acted unreasonably.<sup>32</sup> However, the Supreme Court subsequently denied plaintiffs’ application for interlocutory appeal in *Cogent*, signaling that the Delaware Supreme Court does not seem overly concerned with the way the Court of Chancery is currently approaching appraisal dilution claims in connection with Top-Up options.<sup>33</sup>

#### NOTES

1. See, e.g., *In re Cogent, Inc. S’holder Litig.*, Consol. C.A. No. 578-VCP (Del. Ch. Oct. 5, 2010) (noting “Top-up options have become commonplace in two-step tender offer deals”); *Olson v. EV3, Inc.*, C.A. No. 5583-VCL, Trans. at 31 (Del. Ch. June 25, 2010) (stating that the use of Top-Up options has “skyrocketed”). In fact, 100% of tender offer deals announced in 2008 featured Top-Up provisions. See Mergers & Acquisitions Committee of the American Bar Association’s Business Law Section, 2009 *Strategic Buyer/Public Target Mergers &*

*Acquisitions Deal Points Study*, at Slide 105 (Sept. 10, 2009), available at <http://www.abanet.orgdch/committee.cfm?com+CL560003>. According to MergerMetrics, in 2004, only 35% of friendly tender offers included Top-Up options, compared to 64% in 2006, 94% in 2007, and 100% in 2008. FactSet Mergers, M&A Year End Review, January 23, 2009, available at [https://www.factsetmergers.com/marequest?an=dt.getPage&st=1&pg=/pub/rs\\_20090122.html&rnd=101994](https://www.factsetmergers.com/marequest?an=dt.getPage&st=1&pg=/pub/rs_20090122.html&rnd=101994).

2. *Olson v. EV3, Inc.*, C.A. No. 5583-VCL, Trans. at 30 (Del. Ch. June 25, 2010).

3. In *NECA-IBEW Pension Fund v. Prima Energy Corp.*, Vice Chancellor Lamb denied a motion to expedite in a case involving Top-Up options, noting the utility of Top-Up options to “get the transaction done more quickly so that the remaining shareholders get their money more quickly.” C.A. No. 522-VCL (Del. Ch. June 30, 2004). In *In re Gateway Shareholders Litigation*, Vice Chancellor Noble granted a motion to expedite, but noted that the Top-Up options at issue were “certainly not preclusive or coercive,” and called plaintiffs’ claims “far from compelling.” C.A. No. 3219-VCN, Trans. at 39 (Del. Ch. Sept. 14, 1007). However, because of a “confluence of many different factors” in the unique deal structure, the court scheduled a preliminary injunction hearing. *Id.* at 40. The case subsequently settled, and Vice Chancellor Noble approved the settlement—in which defendants agreed not to assert in any appraisal action that Top-Up shares would be included in a fair value calculation.

4. See Megan Davies, *Tender Offers on Rise, Bring Concerns*, Reuters, Feb. 21, 2008 (quoting Duke University Law School professor James Cox, stating, “the top-up shortens the whole time dimension. The reason they do a top-up is so they don’t have to...have some kind of delay and a shareholder meeting and have to do a straight merger, which lends itself to some attach in the Delaware courts.”); see also J. Travis Laster & Matthew F. Davis, *Catching Up On Top Up Options*, INSIGHTS, Vol. 23, No. 1 (Jan. 2009).

5. The acquirer usually agrees to provide a promissory note bearing interest of a low rate to finance the issuance of the Top-Up shares. According to plaintiffs in *Olson v. EV3*, C.A. No. 5583-VCL, Trans. at 5, such a structure, and particularly the one at issue in the case, meant that “ev3 has agreed to issue up to 186 million shares that will be immediately canceled in exchange for what is merely a promise to make a promise to pay on terms [the acquirer] will specify later, a promise that will never be fulfilled, because the note will never be

- repaid." This is because, assuming the deal is completed, the acquiror would wholly own the company and the note would be cancelled.
6. See J. Travis Laster & Matthew F. Davis, *Catching Up On Top Up Options*, at 11-13.
  7. *Olson v. EV3*, C.A. No. 5583-VCL, Trans. at 30.
  8. *Id.* at 30-31.
  9. *Id.* at 31-32.
  10. *Id.* at 33.
  11. ICX Techs., Inc. Form 8-K, Exhibit 2.1, section 2.9(d), filed with the Securities and Exchange Commission on August 16, 2010.
  12. *In re ICX Techs., Inc. S'holder Litig.*, C.A. No. 5769-VCL, Trans. at 5 (Del. Ch. Sept. 17, 2010).
  13. *Id.* at 6 (holding "now that they are currently saying they are not going to treat the top-up option shares for consideration for purposes of any appraisal action, that is, I think, entirely appropriate").
  14. C.A. No. 19444-NC, 2004 WL 2847865 (Del. Ch. Nov. 24, 2004)
  15. C.A. No. 12089-CC, 2010 WL 26539 (Del. Ch. Jan. 5, revised Feb. 15, 2010)
  16. *In re ICX Techs., Inc. S'holder Litig.*, C.A. No. 5769-VCL, Trans. at 7-8 (Del. Ch. Sept. 17, 2010).
  17. *Id.* at 8.
  18. *Id.*
  19. *Id.* at 6, 8 (stating, "I don't believe you had a claim that was litigable when filed, and therefore it's not something that will support a settlement," and reiterating that "this is [not] the type of case where plaintiffs, frankly, should be able to extract settlement value").
  20. *In re Cogent, Inc. S'holder Litig.*, C.A. No. 5780-VCP (Del. Ch. Oct. 5, 2010). The Court refused to enjoin the cash tender offer, and also rejected plaintiffs' claims that the purchase price was inadequate and the result of a flawed sales process, that the merger agreement contained a number of preclusive deal protection devices, and that the recommendation statement contained inadequate disclosures. See Mem. Op. at 11.
  21. *Id.* at 24 (emphasis added).
  22. *Id.* at 27-28. In support of their claims that the option was statutorily invalid because it was not the result of an informed judgment by the board, plaintiffs asserted that "neither the Cogent Board minutes nor the Recommendation Statement reflects any discussion of the Top-Up Option." *Id.* at 28. However, the Court determined that: "These allegations are refuted convincingly by the deposition of Defendant Bolger, in which he testified that the Board received legal advice regarding the Top-Up Option provisions and that he understood the general nature of its mechanics, including that: (1) it would make the transaction 'a lot more straightforward'; (2) a majority of Cogent shares would have to be tendered before the option would be exercised; and (3) the option would not disadvantage the minority stockholders....Thus, at the very least, Defendants have proffered credible evidence that they made a reasonable effort to be informed as to the mechanics of the Top-Up Option." *Id.*
  23. *Id.* at 29.
  24. *Id.* at 31-32.
  25. *In re Cogent, Inc. S'holder Litig.*, C.A. No. 5780-VCP, Letter Op. at 2 (Del. Ch. Oct. 15, 2010).
  26. *Id.* at 6.
  27. *In re Cogent, Inc. S'holders Litig.*, No. 648, 2010 (Del. Oct. 19, 2010) (denying interlocutory appeal, stating "[w]e have examined the Court of Chancery's October 5, 2010 opinion...and have concluded that exceptional circumstances as would merit review of that decision do not exist in this case").
  28. *In re Protection One, Inc. S'holders Litig.*, C.A. No. 5468-VCS (Del. Ch. Oct. 6, 2010).
  29. *Id.* at 16. See also *id.* at 11-12 ("This is all essentially part and parcel of the transaction that gave rise to appraisal in the first instance.") The Court also asked plaintiffs' counsel, "[w]hat is the concern about these top-up options in appraisal? I'm not sure I get it. The price of the option is set as part of the transaction that gives rise to the appraisal proceeding. So the theory is that the appraisal petitioner gets harmed how?" *Id.* at 10.
  30. *Id.* at 16.
  31. EV3 subsequently settled before trial. Under the terms of the settlement, defendants agreed that the Top-Up option, shares issued pursuant to the Top-Up option, and the promissory note would not be considered as part of a fair value calculation any appraisal action. The defendants also amended the merger agreement to state that the par value of any shares issued pursuant to the Top-Up option would be paid in cash, explicitly set forth the terms of the promissory note, and also amended the merger agreement to state that there would be no amendment to the Top-Up provision after the purchaser became the majority shareholder in a way that would adversely affect the rights of other EV3 stockholders. The settlement is currently awaiting approval by the Court of Chancery.
  32. *In re Cogent, Inc. S'holder Litig.*, C.A. No. 5780-VCP, Letter Op. at 7 (Del. Ch. Oct. 15, 2010).
  33. *In re Cogent, Inc. S'holders Litig.*, No. 648, 2010 (Del. Oct. 19, 2010).