IX. Appraisal Arbitrage: Investment Strategy of Hedge Funds and Shareholder Activists

A. Introduction

In the past couple years the number of appraisal claims in Delaware has sharply increased.[1] From 2004 through 2010, the number of claims represented about "5% of appraisal-eligible transactions . . . ," but that number has increased to more than 15% of eligible transactions in 2013 alone.[2] This upswing in appraisal claims can be attributed to shareholder activists and hedge funds utilizing an investment strategy called "appraisal arbitrage," where a large number of shares of a target company are acquired shortly after a merger is announced with the express purpose of asserting appraisal rights.[3] The Delaware legislature intended appraisal rights to protect minority shareholders, allowing for shareholders to bring an action under title 8, section 262 of the Delaware Code ("Section 262") in the Court of Chancery to appraise the fair market value of the shareholders' shares.[4] The fair value for appraisal purposes is determined exclusive of any value that may be created as a result of the merger, and the court is granted wide discretion in its determination of fair value.[5]

In determining fair value, Delaware courts typically use a discounted cash flow analysis, which involves determining future cash flows and discounting them to present value based on projected data

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[1] Charles R. Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASH. U. L. REV. (forthcoming 2015) (manuscript at 16), *available at* http://ssrn.com/abstract=2424935.

[2] *Id.*

[3] FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP, *New Activist Weapon--The Rise of Delaware Appraisal Arbitrage: A Survey of Cases and Some Practical Implications* 1 (June 18, 2014), http://www.friedfrank.com /siteFiles/Publications/FINAL%20-%206182014%20TOC%20Memo%20- %20New%20Activist%20Weapon--%20The%20Rise%20of%20Delawar e% 20Appraisal%20Arbitrage.pdf, *archived at* http://perma.cc/6S82-V6EB.

[4] George S. Geis, *An Appraisal Puzzle*, 105 NW. U. L. REV. 1635, 1636 (2011).

[5] DEL. CODE ANN. tit. 8, § 262 (2011) ("Through such proceeding the Court shall determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with interest, if any, to be paid upon the amount determined to be the fair value. In determining such fair value, the Court shall take into account all relevant factors.").

about how the company would perform independent of the merger.[6] This appraisal arbitrage investment strategy is considered so lucrative that more hedge funds are integrating appraisal claims into their investment strategy, and managers have set up entire funds with the sole purpose of pursuing appraisal claims.[7] As a result, over 80% of appraisal claims involve a petitioner, typically a hedge fund, which had previously filed an appraisal claim.[8] Three particular funds alone have already brought over ten appraisal claims each.[9]

This Article outlines the development of appraisal arbitrage, discusses the effects of appraisal arbitrage strategy, and considers recent challenges to the use of appraisal arbitrage. First, Part B discusses the factors that led to the rise of the use of appraisal arbitrage as an investment strategy. Next, Part C provides an overview of selected recent appraisal actions and their results. Part D then discusses the effects of appraisal arbitrage on mergers and acquisitions. Finally, Part E analyzes challenges to the use of appraisal arbitrage as an investment strategy.

B. Rise of Appraisal Arbitrage as an Investment Strategy

Several factors have contributed to the rise of using appraisal rights as part of an investment strategy.[10] One of the main contributors is the Delaware Court of Chancery's decision in *In re Appraisal of Transkaryotic Therapies, Inc.*,[11] which helped bring this arbitrage opportunity into existence.[12] Section 262 only allows appraisal rights to be asserted by shareholders who abstained or voted against the merger.[13] In *Transkaryotic*, the shareholders who decided to file an

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[6] *In re* Appraisal of Orchard Enter., Inc., No. 5713-CS, 2012 WL 2923305, at *11 (Del. Ch. July 18, 2012).

[7] Steven M. Davidoff, *New Form of Shareholder Activism Gains Momentum*, N.Y. TIMES, Mar. 5, 2014, at B5.

[8] Korsmo & Myers, *supra* note 1, at 18.

[9] *Id.*

[10] *See infra* notes 11–24 and accompanying text (showing that the *Transkaryotic* decision and the favorable statutory interest rates are the main contributing factors to the rise of appraisal arbitrage).

[11] *In re* Appraisal of Transkaryotic Therapies, Inc., No. 1554-CC, 2007 WL 1378345 (Del. Ch. May 2, 2007).

[12] *Id.* at *3; Korsmo & Myers, *supra* note 1, at 23.

[13] DEL. CODE ANN. tit. 8, § 262 (2011) ("Any stockholder . . . who has neither voted in favor of the merger or consolidation nor consented thereto in writing

appraisal claim had purchased their shares after the record date for the vote on the merger.[14] The issue was therefore whether (1) the shares the petitioners purchased had been used to vote in favor of the merger, which would preclude them from bringing their appraisal claim, or (2) the shares had abstained or voted against the merger, which would allow them to bring the appraisal claim.[15]

In the modern era, shares are typically held in clearinghouses and votes from these shares are also executed through these clearinghouses.[16] As a result of the clearinghouse system, it has become impossible to tell which shares the petitioners purchased, and therefore how the previous owners of the purchased shares voted with them.[17] The *Transkaryotic* court ultimately decided that shares purchased after the record date could still be used to assert appraisal rights as long as the number of shares asserting appraisal rights is equal to or less than the number of shares that had either abstained or voted against the merger.[18] The *Transkaryotic* court therefore created a timing advantage for activist shareholders and hedge funds to delay purchasing a target company's shares until the very last minute.[19] This timing advantage allows for prospective appraisal investors to make better investment decisions by having more time to consider the most current market, industry, and company information.[20]

The method of calculating interest used in appraisal claims imposed by Section 262 is another key contributing factor.[21] The statutory interest rate is set so that "[i]nterest from the effective date of the merger through the date of payment of the judgment shall be compounded quarterly and shall accrue at 5% over the Federal Reserve discount rate . . . ."[22] This interest rate is well above the current market rate, which is currently 0.75% and effective since February 2010.[23]

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pursuant to § 228 of this title shall be entitled to an appraisal by the Court of Chancery . . . .").

[14] *Transkaryotic Therapies, Inc.*, 2007 WL 1378345, at *1.

[15] *Id.*

[16] Geis, *supra* note 4, at 1637.

[17] *Id.*

[18] *Transkaryotic Therapies, Inc.*, 2007 WL 1378345 at *4.

[19] Korsmo & Myers, *supra* note 1, at 2.

[20] *Id.* at 24.

[21] *See id.*

[22] DEL. CODE ANN. tit. 8, § 262 (2011).

[23] *Current Discount Rates,* FED. RES. DISCOUNT WINDOW & PAYMENT SYS. RISK, https://www.frbdiscountwindow.org/en/Pages/Discount-Rates/Current-Discount-Rates.aspx, *archived at* http://perma.cc/SN6G-W5PY (last visited

Thus, even if the court determines that the fair value is in fact equal to the merger price, 5.75% is a very profitable rate of return, making appraisal arbitrage all the more lucrative and attractive as an investment strategy.[24]

C. Current Appraisal Actions and their Resulting Valuations

Between 2010 and 2013, nine Delaware cases have gone through the entire appraisal process and had the court issue a determination of fair market value.[25] Out of these nine cases, seven have resulted in a fair market value higher than the original merger price.[26] Of these seven cases with fair values higher than the merger price, the court deemed five of the cases to involve "interested transactions"[27] while only two were "disinterested transactions."[28] As for the two cases that did not result in a higher fair value, both were also "disinterested transactions," with one resulting in a fair value equal to the merger price and one resulting in a fair value lower than the

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Sept. 29, 2014) (presenting a graph that illustrates 0.75% interest rate for all districts in the Federal Reserve System).

[24] Davidoff, *supra* note 7.

[25] FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP, *supra* note 3, at 3.

[26] *Id.*

[27] Laidler v. Hesco Bastion Envtl., Inc., No. 7561-VCG, 2014 WL 1877536, at *1 (Del. Ch. May 12, 2014) (finding that the company did not conduct a market check or auction); Towerview LLC v. Cox Radio, Inc., No. 4809-VCP, 2013 WL 3316186, at *1 (Del. Ch. June 28, 2013) (assessing interestedness in a parent-subsidiary merger); *In re* Appraisal of Orchard Enter., Inc., No. 5713-CS, 2012 WL 2923305, at *11 (Del. Ch. July 18, 2012) (finding control in a going-private transaction); Global GT LP v. Golden Telecom, Inc., 993 A.2d 497, 508 (Del. Ch. 2010) (remarking that the board's "Special Committee did not engage in any sales efforts at all and instead concentrated solely on getting as good a deal as it could from [one buyer] . . . ."); *In re* Sunbelt Beverage Corp. S'holder Litig., No. 16089-CC, 2010 WL 26539, at *5 (Del. Ch. Jan. 5, 2010, revised Feb. 15, 2010) (reviewing under entire fairness in the context of an appraisal action).

[28] Merion Capital LP v. 3M Cogent, Inc., No. 6247-VCP, 2013 WL 3793896, at *2 (Del. Ch. July 8, 2013) (summarizing the retention of external advisors and the pursuit of transactional alternatives in a disinterested acquisition); IQ Holdings, Inc. v. Am. Commercial Lines Inc., No. 6369-VCL, 2013 WL 4056207, at *2 (Del. Ch. Mar. 18, 2013) (finding that the company performed a market check because it "reached out to 86 potentially interested bidders and signed confidentiality agreements with 13 of them.").

merger price.[29] A court's determination of "interestedness" can therefore have a substantial impact on appraisal petitioners' share valuation, as discussed *infra* Parts C.1 and C.2.[30]

1. Interested Transaction Cases

Delaware courts consider a transaction to be "interested" if it involves a majority shareholder buying out the minority shareholders or a parent-subsidiary merger.[31] The court-determined fair market values in these "interested" cases were substantially above the merger price, ranging from a 19.5% premium up to a 148.8% premium over the merger price, all before taking into account the statutory interest rate.[32] One reason for these substantial premiums may be the fact that appraisal rights are intended to protect minority shareholders.[33] These five "interested" cases involved board failures to perform adequate "market checks."[34] Such market checks would have involved reaching out to a multitude of bidders to allow for a competitive sale, and thus a fair price for the company.[35] In fact, in the two cases that awarded the highest fair valuations, both companies completely failed to canvas the market for competitive bids.[36] Thus, the substantiality of the premium over the merger price is directly correlated with the amount of protection afforded to the minority shareholders.[37]

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[29] FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP, *supra* note 3, at 3.
[30] *See infra* notes 31–45 and accompanying text (assessing the impact that non-conflicted bidding processes have on the court's ultimate valuation in a sample of Delaware cases).
[31] *See Sunbelt Beverage Corp S'holder Litig.*, 2010 WL 26539, at *5.
[32] FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP, *supra* note 3, at 3.
[33] *See* Geis, *supra* note 4.
[34] Laidler v. Hesco Bastion Envtl., Inc., No. 7561-VCG, 2014 WL 1877536, at *1 (Del. Ch. May 12, 2014); Towerview LLC v. Cox Radio, Inc., No. 4809-VCP, 2013 WL 3316186, at *1 (Del. Ch. June 28, 2013); *In re* Appraisal of Orchard Enter., Inc., No. 5713-CS, 2012 WL 2923305, at *1 (Del. Ch. July 18, 2012); Global GT LP v. Golden Telecom, Inc., 993 A.2d 497, 508 (Del. Ch. 2010); *Sunbelt Beverage Corp. S'holder Litig.*, 2010 WL 26539, at *5.
[35] *See* Geis, *supra* note 4, at 1661–65.
[36] *Laidler*, 2014 WL 1877536, at *1; *Sunbelt Beverage Corp. S'holder Litig.*, 2010 WL 26539, at *5.
[37] *See Laidler*, 2014 WL 1877536, at *1; *Sunbelt Beverage Corp. S'holder Litig.*, 2010 WL 26539, at *5.

2. Disinterested Transaction Cases

On the other hand, Delaware courts consider third party arm's length transactions to be "disinterested transactions."[38] The two "disinterested" cases that determined that the fair value should be above the merger price had premiums of only 8.5% and 15.6%, substantially lower than those in the "interested" cases.[39] In *Huff Fund Inv. P'ship v. CKx, Inc.*,[40] however, the court determined that the fair value was equal to the merger price because the sale process was a competitive auction, which involves a full market check and does not present the conflicts of interest typified in the "interested" cases.[41] Thus, the court deemed the merger price to be a reasonable measure of fair value.[42] In *Gearreald v. Just Care, Inc.*,[43] the court actually determined that the fair value was below the merger price because the merger price had been based on data prepared by the same shareholders that were seeking the appraisal action.[44] Therefore, the lower premiums were most likely due to the fact that "disinterested transactions" were more likely to afford minority shareholders the protections of a rigorous market check than in "interested transactions."[45]

D. Effects and Implications of Appraisal Arbitrage on Mergers and Acquisitions

The increasing use of appraisal arbitrage by shareholder activists and hedge funds as an investment strategy has many implications for the mergers and acquisitions ("M&A") market.[46] One of the most obvious implications is that potential buyers of companies

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[38] *See* Highfields Capital, Ltd. v. AXA Fin., Inc., 939 A.2d 34, 42 (Del. Ch. June 27, 2007).

[39] FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP, *supra* note 3, at 3; *see* Merion Capital LP v. 3M Cogent, Inc., No. 6247-VCP, 2013 WL 3793896, at *26 (Del. Ch. July 8, 2013); IQ Holdings, Inc. v. Am. Commercial Lines Inc., No. 6369-VCL, 2013 WL 4056207, at *3–*4 (Del. Ch. Mar. 18, 2013).

[40] No. 6844-VCG, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013).

[41] *Id.* at *1.

[42] *Id.* at *15.

[43] No. 5233–VCP, 2012 WL 1569818 (Del. Ch. Apr. 30, 2012).

[44] *Id.* at *4.

[45] *See Huff Fund*, 2013 WL 5878807, at *11–*14; *Gearreald*, 2012 WL 1569818 at *5–*15.

[46] *See infra* notes 47–60 and accompanying text (laying out practitioners' responses to the appraisal strategy's effect on the M&A market).

must now assess the possibility of appraisal actions being brought against them in the M&A transactions that they wish to enter into.[47] Buyers may easily determine whether or not appraisal claims will be pursued in certain circumstances.[48] In "interested transactions" with little or no market checks, purchasers can anticipate a higher likelihood of an appraisal claim against them.[49] On the other hand, "disinterested transactions"—which are subject to a vigorous competitive sale and a full market check—will likely not be subject to an appraisal action.[50] In these cases, it would be easy to determine the impact appraisal arbitrage would have on the transaction, and thus buyers can account for these effects when considering an acquisition.[51] Nonetheless, for transactions that are between "interested" and "disinterested," buyers would be required to carefully consider all actions taken by the negotiating parties to determine the threat of an appraisal action and the subsequent effects of those actions on the transaction.[52]

The next major implication of appraisal arbitrage is the rising uncertainty in the acquiror's calculation of an appropriate merger price.[53] The increase in appraisal claims directly increases the risk to buyers that there may be excessive post-closing costs incurred through the appraisal action.[54] There is also a significant amount of uncertainty as to how the court will determine fair market value in any particular case; as discussed *supra* Part C.2 for disinterested transactions, there are three possible outcomes for fair value—above, below, or equal to the merger price.[55]

To deal with this increase in risk and uncertainty, buyers may push for the inclusion of "appraisal conditions" in the merger deals.[56] Appraisal conditions typically state that an M&A transaction would be

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[47] *See* FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP, *supra* note 3, at 4–5.
[48] *Id.*
[49] *Id.* at 4.
[50] *Id.* at 4–5.
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *See* LATHAM & WATKINS LLP, *Appraisal Arbitrage: Will It Become a New Hedge Fund Strategy?* (May 2007), http://www.lw.com/upload/pubcontent/_pdf/pub1883_1.pdf, *archived at* http://perma.cc/6657-GTTW.
[55] FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP, *supra* note 3, at 5; *see supra* notes 38–45 and accompanying text (reporting the fair valuation price against the merger price in four disinterested transaction cases).
[56] LATHAM & WATKINS LLP, *supra* note 54.

discontinued if more than a specified percentage of outstanding shares pursue an appraisal action.[57] However, inclusion of an appraisal condition may make a particular buyer's offer less attractive to the seller in comparison to offers from buyers who are willing to eschew the appraisal condition.[58] Appraisal conditions effectively reallocate the risk and uncertainty of the buyer to the seller, thus creating risk and uncertainty for sellers that have accepted an appraisal condition as part of the transaction.[59] Even when both the buyer and seller agree to the inclusion of an appraisal condition, both still face the risk that the entire deal would be disrupted by a large shareholder pursuing an appraisal action and activating the condition.[60]

E. Challenges to Appraisal Arbitrage

One appraisal case currently in litigation in the Delaware Court of Chancery as of the date of publication is between Ancestry.com Inc., which Permira—a private equity firm—bought in 2012, and the hedge fund Merion Capital LP, in which Ancestry.com is challenging the use of appraisal arbitrage by Merion.[61] Since appraisal actions can only be brought by shareholders who abstained or voted against a deal, and Merion bought their shares after the record date, Ancestry.com argues that Merion had purchased its shares too late and cannot prove that the shares were not voted in favor of the deal.[62] Ancestry.com is arguing for the court to place the burden of proof on Merion to show that the specific shares Merion purchased were not used to vote in favor of the deal.[63] If the court rules in favor of Ancestry.com, pursuing appraisal claims may no longer be a viable investment strategy for hedge funds.[64]

If the court sides with Ancestry.com and holds that an appraisal petitioner is required to prove how their specific shares voted, the court

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[57] FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP, *supra* note 3, at 5.
[58] LATHAM & WATKINS LLP, *supra* note 54.
[59] FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP, *supra* note 3, at 5.
[60] *Id.*
[61] Verified Petition for Appraisal, *In re* Appraisal of Ancestry.com, Inc., No. 8173-VCG (Del. Ch. filed Jan. 3, 2013) [hereinafter Ancestry Appraisal Petition]; Liz Hoffman, *Hedge Fund 'Appraisal Arbitrage' Strategy Faces Court Challenge*, WALL ST. J. (June 19, 2014, 4:06 PM), http://online.wsj.com/articles/hedge-fund-appraisal-arbitrage-strategy-faces-court-challenge-1403208384.
[62] Hoffman, *supra* note 61.
[63] *Id.*
[64] *Id.*

would create an obstacle that could make appraisal actions more difficult for individual minority shareholders.[65] This follows logically from the fact that, as discussed *supra* Part B, votes are normally cast through clearinghouses, making it very difficult to track how each specific share has voted.[66]

Certain practical concerns also counsel in favor of holding for Merion in this case. First, the availability of appraisal actions, along with shareholder activism generally, is important in protecting minority shareholders from being cheated by controlling shareholders and other parties in M&A transactions.[67] Furthermore, parties to a merger transaction can manage the deal risks associated with appraisal arbitrage through the use of appraisal conditions and other risk-allocating devices.[68] Additionally, the Delaware legislature—rather than the Delaware Court of Chancery—can statutorily amend the use of appraisal rights by shareholder activists and hedge funds.[69] Finally, if the Delaware Court of Chancery holds for Ancestry.com, such a decision would be inconsistent with its holding in *In re Appraisal of Transkaryotic Therapies, Inc.*,[70] which stood for the proposition that shares purchased after the record date could still be used to assert appraisal rights.[71]

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[65] *See id.*

[66] *See supra* notes 16, 17 and accompanying text (describing how the clearinghouse system creates tracking problems for determining how a specific share voted on a merger transaction).

[67] *See supra* notes 31–37 and accompanying text (summarizing the amount of premiums awarded to appraisal petitioners in "interested" transaction cases).

[68] *See* FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP, *supra* note 3, at 5; LATHAM & WATKINS LLP, *supra* note 54.

[69] *See* Karlee Weinmann, *Hedge Funds Willing to Shoulder Risk As Appraisals Heat Up*, LAW360 (June 16, 2014, 5:38 PM), http://www.law360.com/articles/547370/hedge-funds-willing-to-shoulder-risk-as-appraisals-heat-up.

[70] No. 1554-CC, 2007 WL 1378345 (Del. Ch. May 2, 2007).

[71] *Id.* at *4; *see* Leonard Loventhal Account v. Hilton Hotels Corp., 780 A.2d 245, 248 (Del. 2001) ("The doctrine *of stare decisis* finds ready application in Delaware corporate law.")

F. Conclusion

Hedge funds are increasingly pursuing appraisal claims as an investment strategy due to the Delaware Court of Chancery's decision in *Transkaryotic,* which created an arbitrage opportunity for these hedge funds to exploit.[72] In addition to this decision, the favorable statutory interest rates imposed by Section 262 make this investment strategy all the more attractive to hedge funds.[73] Coupled with this rise in appraisal arbitrage is an overall increase in risk and uncertainty of M&A transactions.[74] However, this risk increase remains manageable because many beneficial deals can continue to occur while minority shareholders retain the ability to protect themselves from abuse by majority shareholders.[75] Although Ancestry.com is now fighting back against the use of appraisal arbitrage by Merion Capital LP, the Delaware Court of Chancery may be wise to agree with Merion.[76] If the court finds in favor of Ancestry.com and requires shareholders to prove how their shares were voted before bringing an appraisal action, appraisal arbitrage could become much more difficult to the detriment of minority shareholders.[77] Such a decision could discourage shareholder activism generally, and weaken the statutory mechanisms designed to protect minority shareholders.[78]

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[72] *See supra* notes 12–20 and accompanying text (explaining the timing advantage created by the *Transkaryotic* decision and hedge funds' subsequent exploitation).
[73] DEL. CODE ANN. tit. 8, § 262 (2011).
[74] *See* FRIED, FRANK, HARRIS, SHRIVER & JACOBSON LLP, *supra* note 3, at 4–5.
[75] *See supra* notes 33–37 and accompanying text (describing the importance of the appraisal right in discouraging management from exploiting minority shareholders in "interested" transactions).
[76] *See* Ancestry Appraisal Petition, *supra* note 61.
[77] *See supra* notes 65–71 and accompanying text (implying that the Delaware Court of Chancery should rule in favor of Merion Capital LP).
[78] *See* Geis, *supra* note 4, at 1636, 1662.
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