LATHAM & WATKINS LLP

M&A Deal Commentary

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Appraisal Arbitrage: Will It Become a New Hedge Fund Strategy?

Highlights

A recent Delaware case involving the acquisition of Transkaryotic Therapies by Shire Pharmaceuticals has the potential to revolutionalize the use of appraisal rights in cash mergers involving Delaware target companies.

- The opinion holds that investors that buy target company shares after the record date may assert appraisal rights so long as the aggregate number of shares for which appraisal is being sought is less than the aggregate number of shares that either voted no on the merger or didn't vote on the merger.
- A likely effect of this decision will be to encourage aggressive investors (for example, hedge funds and arbitragers) to examine every cash merger in Delaware for suitability for appraisal claims with the goal of either negotiating a settlement of the claims after the merger or convincing an appraisal court that the value of the shares was higher than the merger price.
- Suitability for appraisal claims will likely be coincident with high investor resistance to the transaction characterized by claims of inadequate consideration and a large number of no votes/failures to vote.
- Companies may be particularly vulnerable in private equity acquisitions of public companies—so-called "take private" deals that seem increasingly to meet with significant investor resistance.
- As a result, buyers and sellers of public companies, particularly in take private transactions, are bound to focus on the desirability of including a condition to the merger that no more than 5% or 10% of the outstanding shares are subject to appraisal claims.
- Counter-intuitively, such a condition may encourage, rather than discourage, appraisal "arbitrage." As a result, buyers may in fact be better off foregoing an appraisal condition and accepting the full economic risk of appraisal.

Background

Appraisal rights have historically been a back-water of the public company M&A process and practice, largely ignored and often thought irrelevant. As a result, the once common merger closing condition capping the number of shares seeking appraisal has virtually disappeared from public company merger agreements. A recent Delaware case, however, may well make this state of affairs, in the famous words of Edgar Allan Poe's Raven, "nevermore."

In the first week of May the Delaware Chancery Court issued its opinion in the *Transkaryotic* appraisal proceedings. The issue was whether some 10 million *Transkaryotic* shares acquired after the record date largely by hedge funds and arbitragers were entitled to appraisal even though the beneficial owners could not demonstrate that the particular shares had, in fact, either been voted against the merger transaction or had not voted at all—a statutory prerequisite for asserting appraisal rights.

The court ruled that the beneficial holders seeking appraisal did not have to establish how the specific shares they acquired after the record date were voted—which the parties to the litigation and the court agreed would be a practical impossibility. Rather, the Court embraced Cede as the holder of record and ruled that so long as beneficial owners of fewer than the aggregate number of Cede shares that were eligible for appraisal (that is, Cede shares either voted against the merger or not voted) directed Cede to seek appraisal, those shares would meet the statutory requirement and be eligible for appraisal

The Advent of an Appraisal Rights Investment Strategy

Assuming that the Chancery Court's decision is not reversed on appeal, it heralds a major new chapter in the appraisal rights remedy and a corresponding significant challenge to current public M&A deal structures and outcomes.

- First and foremost, the decision will allow the creation of a new "market" in appraisal rights. Historically, appraisal rights have rarely been invoked in public company acquisitions because of a seemingly common assumption that only beneficial owners on the record date who issued appropriate no vote instructions to the record holder would be able to establish eligibility for appraisal. This assumption was made more powerful by the fact that the record date for an M&A transaction almost always precedes distribution of the proxy statement, thus requiring investors who are contemplating appraisal to establish their ownership position without the benefit of proxy statement disclosures about the M&A process and M&A valuation metrics underlying investment banker fairness opinions.

- An important consequence of the *Transkaryotic* decision is that investors are now free to assess the economics of appraisal and make the requisite investment literally until the date of the shareholder meeting, so long as there is a significant no vote for the transaction. In effect, the opinion permits the creation of a post record date market in appraisal rights and an investment strategy of seeking out appropriate merger transactions in which to establish large scale appraisal positions after the record date and before the meeting date.

- Prior to the *Transkaryotic* merger there had been intermittent discussion of the viability of an investment strategy premised on asserting appraisal rights, rather than accepting the merger consideration and moving on. There does not, however, seem to have been a large scale test of the investment thesis until the *Transkaryotic* transaction, which gave rise to an appraisal claim involving close to 11 million shares and more than $400 million in value at the merger price of $37. The test has successfully passed its first major hurdle and, absent reversal by the Delaware Supreme Court, is headed for either a negotiation of a price increase for the appraisal shares or a judicial determination of the intrinsic value of the Transkaryotic shares against the backdrop of a merger which received only a 52% affirmative vote and much contemporary opinion that the company was being sold too cheaply.

- Nor is it clear that the market will wait for the results in *Transkaryotic* before embarking on another major appraisal "raid." The past six months have witnessed an ever increasing number of announced merger transactions that are being openly criticized by many investors as significantly undervalued—Clear Channel, Genesis Healthcare, Topps, Laureate and most recently Cablevision, to name a few of the more prominent. These and other deals are being challenged at the ballot box with sufficient success to require price increases, removal of deterrents to topping bids and creative new structures, such as the proposal in the take private transaction for Harman Industries to allow all public shareholders to participate in the economics of the LBO through ownership of an "equity stub" in resulting company. It is not far-fetched that some aggressive investors will seize the opportunity to seek appraisal of significant blocks of stock in deals like these where the adequacy of the consideration is hotly debated and in all likelihood there will be a large no vote on the scale of the *Transkayotic* transaction.

Implications for the M&A Market

First, it is important to note that not every transaction is subject to appraisal. In Delaware, appraisal is available in all cash deals, but not in most stock deals. In Maryland, appraisal is not available for listed target stocks, whether the buyout currency is cash or stock. Accordingly, the universe of M&A transactions in which there is a possibility of appraisal is narrower than the universe of deals. Because of the prevalence of Delaware as the state of incorporation of targets, however, it is safe to generalize that the vast majority of cash deals, including private equity take-privates, have an imbedded appraisal risk.

- If, as seems likely, appraisal claims will become more frequent and larger, how should buyers and sellers allocate the risk? Historically, it was common in public company deals to find closing conditions pegged to the absence of appraisal claims in excess of typically 5-10% of the total number of shares. While appraisal rights closing conditions have fallen out of favor for public company acquisitions, that trend will be re-examined and the risk allocation function of the closing condition will assume far more importance than previously assumed.

- At first blush, the risk allocation seems simple. Buyers, particularly financial buyers, will want an appraisal condition set at a relatively low threshold to avoid the risk of significant appraisal awards. Sellers, with their strong stake in closing certainty, will resist any appraisal closing condition and, if they accede to one, will want it to be relatively high. In this context, buyers will point out that the closing condition can be waived, that they can be trusted not to abuse the condition and that they will invoke it only if there is large scale resort to appraisal. Sellers will counter that the condition gives the buyer a “free” option and that trust is not an appropriate currency when the interests of shareholders are at stake. The outcome of the negotiation will vary, but it almost certainly will be difficult and potentially “deal-braking.”

- This analysis, however, may be too superficial. Insertion of an appraisal closing condition creates “blocking” value for aggressive investors in search of higher returns. An appraisal closing condition invites the very behavior both buyer and seller would like to discourage. Moreover, it does so in the context of a transaction headed for a favorable shareholder vote and a closing—a negotiating posture that increases the leverage of the investors threatening appraisal. It also does so at a time when the investors can threaten to seek appraisal, but are not committed to follow through, which further increases the investors’ ability to take an intractable position without negative consequences, creating what game theory sometimes labels a "free rider" situation. Finally, the buyer cannot make any price concession to the investors without paying the higher price to all shareholders. In sum, an appraisal condition sets up a very unfavorable negotiating dynamic for the buyer and is not in the long-term interests of the seller.

- The alternative, of course, would be for buyers to continue to eschew an appraisal closing condition and thereby reduce the “blocking” value of the appraisal investment strategy. While going this route would not eliminate the risk of appraisal in size, it would eliminate the “free rider” dynamic created by an appraisal condition. Instead, it would create a very different post-closing negotiating dynamic in which the investor has its equity at risk in terms of time and outcome. The longer and more contentious the appraisal process, the lower the investors’ expected internal rate of return and the higher its implied discount rate on a favorable outcome. The buyer, by definition, benefits from being on the other side of the negotiation with delays in resolution and uncertainty in outcome increasing its economic calculus. Finally, and not insignificantly, the buyer does not have to pay any settlement or appraisal award to other former shareholders of the target. Contrast paying an extra 5% or 10% of the consideration to all shareholders at merger closing with paying the same amount to holders of 10% or 20% of the shares months or even years after closing.

- Structuring a transaction without an appraisal closing condition or closing in spite of a condition that has been triggered should be a very appealing strategy for strategic buyers. But what about financial buyers and their financing sources? Can they afford the risks inherent in this strategy? Some financial buyers will have the resources and confidence to go forward without an appraisal closing condition, preferring a post closing negotiation with the investors seeking appraisal to the unenviably adverse negotiating posture that would be created by a closing condition. Others will not.

Conclusion

The *Transkaryotic* case will heighten the attractiveness of an investment strategy premised on assertion of appraisal rights and lead to more frequent and larger appraisal claims than previously. How the M&A market will respond is less certain. Initially there will be more negotiation and more heated negotiation around an appraisal rights closing condition. In the longer run, the pendulum could well swing back to the current prevailing deal structure that does not include an appraisal condition.

In sum, the future of the appraisal condition will be directly related to whether and what extent investors embrace an aggressive appraisal rights strategy. This, in turn, will be a function of a number of factors, including the initial reaction of buyers and sellers in terms of utilizing appraisal conditions and in terms of post-closing negotiation and litigation strategies, the continued prevalence of cash buy-outs particularly by private equity sponsors, the pricing of those deals and the results of judicial determinations of value in appraisal cases.

If you have any questions about this M&A Deal Commentary, please contact Charles Nathan in our New York office.