KIRKLAND **M&A UPDATE**

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Crossing State Lines Again – Appraisal Rights Outside of Delaware

Even as the Delaware appraisal rights landscape continues to evolve, dealmakers should not assume that the issues and outcomes will be the same in transactions involving companies incorporated in other states.

Although once an afterthought on the M&A landscape, in recent years appraisal rights have become a prominent topic of discussion among dealmakers. In an earlier *M&A Update* we discussed a number of factors driving the recent uptick in shareholders exercising statutory appraisal remedies available in cash-out mergers. With the recent Delaware Supreme Court decision in *CKx* and Chancery Court opinion in *Ancestry.com*, both determining that the deal price was the best measure of fair price for appraisal purposes, and the upcoming appraisal trials for the Dell and Dole going-private transactions, the contours of the modern appraisal remedy, and the future prospects of the appraisal arbitrage strategy, are being decided in real-time. These and almost all of the other recent high-profile appraisal claims have one thing in common — the targets in question were all Delaware corporations and the parties have the benefit of a well-known statutory scheme and experienced judges relying on extensive (but evolving) case law. But, what if the target is not in Delaware?

Outside of Delaware, courts often have little or no experience deciding appraisal actions, particularly in the public company context, because very few appraisal claims have been litigated in those states. Also, relying on, or even taking direction from, Delaware precedent is not always an option because of the significant differences in other jurisdictions' appraisal regimes. Below is a brief, and generalized, series of examples of certain unique appraisal provisions in other states along with a comparison to the corresponding Delaware rules, illustrating the point that, in evaluating appraisal risk, dealmakers must pay close attention to the appraisal regime in the relevant jurisdiction of the target company.

Triggering Events Generally — Although discussions of appraisal rights usually arise in the context of mergers, in most states shareholders are entitled to appraisal rights on a host of other extraordinary transactions such as significant asset sales, charter amendments and corporate conversions/domestications.

- *Transformative Transactions* — In Delaware, transactions that may be the economic equivalent of a merger do not trigger appraisal rights. But, in other jurisdictions including Virginia, Texas and New York, many other extraordinary transactions on which shareholders are required to vote, including dispositions of substantially all of the assets as well as certain charter amendments, also give rise to appraisal rights.

- *Acquirer Shareholders* — In a few states, including Ohio, acquirer shareholders may also be entitled to dissenters' rights in connection with majority share acquisitions and combinations involving the issuance of a significant percentage of the buyer's shares. For example, in the 2005 stock-for-stock acquisition of Gillette, a Delaware corporation, by Ohio-incorporated Procter & Gamble, P&G's issuance of more than 30% of its shares to Gillette holders constituted a "majority share acquisition" entitling P&G shareholders to dissent. The curious result was that the target Gillette shareholders did not have appraisal rights because of the market-out exception in Delaware (described below), while the acquirer P&G shareholders could dissent. The parties addressed the resulting risk by conditioning the deal on no more than 5% of P&G's shareholders exercising dissenters' rights, which was met and the transaction closed as planned.

Market-Out Exception — Even if an extraordinary corporate transaction triggers appraisal rights, a shareholder of a public company may not be entitled to appraisal rights if the target's state provides for a "market out" exception to appraisal. The logic behind this exception is that the public markets serve as an independent check on valuation, removing the need for a court's determination of fair value. Speaking generally, in Delaware, if a target shareholder holds publicly traded stock, then the shareholder is not entitled to appraisal rights (unless the shareholder is required to accept in the merger any consideration other than publicly traded

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stock). But there are many other variations on the market-out exception. In some states such as New York and New Jersey, the "market-out" exception applies even if the public company target shareholders receive cash in the merger. Other states, such as Maryland and Massachusetts, reverse the "market-out" exception in conflict or interested party transactions.

When is Fair Value Measured — In Delaware, the court is tasked with appraising the fair value of the company immediately prior to the *completion* of the merger, which may be months after the deal price was struck (but without giving effect to any of the anticipated benefits of the merger, such as synergies). By comparison, in California, the fair value for dissenters is appraised as of immediately prior to the *announcement* of the relevant transaction. New York's statute directs the court to measure as of the close of business on the day prior to the date of the *shareholder vote* but also to take account of the impact on value of the transaction giving rise to the appraisal remedy. These discrepancies in measurement directives mean that the arbitrage opportunity, while present in each case, will differ significantly based on economic and market conditions, as well as target company performance and deal synergies.

Timing of Payment — One of the frequently cited reasons for the recent uptick in appraisal rights proceedings is the fact that Delaware awards dissenters the right to receive interest (at 5% above the Fed discount rate) on the fair value of their shares from the closing date until the award is actually paid, irrespective of the ultimate outcome of the appraisal proceedings — a relatively meaningful arbitrage opportunity itself in today's low interest rate environment. The interest is meant to compensate the shareholders for the fact that, if they exercise appraisal rights, they do not receive any consideration for their shares until the end of the appraisal proceedings. This accruing interest can also represent a significant additional cost to the company, with the Chancery Court recently deciding in *CKx* that the Delaware statute did not permit companies to pre-pay the petitioner the deal price as a means of stopping the accrual of interest on at least that portion of a potential appraisal award. (It is worth noting that the Delaware bar recently proposed amendments to the Delaware appraisal statute, which, if adopted, would reverse the impact of the *CKx* decision and permit a company to cut off the accrual of interest by pre-paying to dissenting shareholders an amount chosen by the corporation, with interest only accruing on any excess of the final appraisal award over the prepaid amount).

Many states such as Illinois, Massachusetts and North Carolina have tried to remedy the cash-flow problem faced by dissenting shareholders by requiring the corporation to pay upfront its estimate of the fair market value for the dissenters' shares (with companies often choosing to pay the deal price). Then, at the end of the appraisal proceedings, the corporation must pay to the shareholder the excess (if any) of the appraised fair value over the estimated payment. While this construct represents a sizeable down-payment by the company on the fair value that may ultimately be awarded and potentially provides funds for the shareholder to finance the costly appraisal proceeding, it also allows the company to significantly reduce the impact of interest accrual during the pendency of proceedings. Importantly, it also serves as a floor for the ultimate fair value award by a court. While in Delaware a shareholder is at risk of a court ultimately determining that fair value for appraisal purposes was less than the deal value, under these down-payment regimes the petitioning shareholders' downside exposure is eliminated.

Washington's statute includes an interesting exclusion to its down-payment requirement. Under an "anti-arb" exception, the company is not required to make the mandatory down-payment to any shareholders who acquired the shares after the announcement of the deal, meaning that such a post-signing buyer will be exposed to the cash-flow issue should they choose to later exercise dissenters' rights.

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Even as the Delaware appraisal rights landscape continues to evolve, dealmakers should avoid assuming that the issues and outcomes will be the same in transactions involving companies incorporated in other states. The relevant statutory regime, as well as the judicial fair value exercise, may produce unexpected results.

Please see our earlier *M&A Update* ("Crossing State Lines — Cautionary Tender Offer Tales") for a similar description of unique, and often quirky, provisions in non-Delaware jurisdictions impacting tender offers.

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