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Dissenting-Shareholders Clauses May Become More Common

Law360, New York (February 20, 2014, 1:53 PM ET) -- A dissenting-shareholders condition in a merger agreement permits an acquirer[1] not to close the merger if the holders of more than a specified percentage of outstanding shares exercise appraisal rights. Generally, appraisal rights allow a shareholder of a corporation that has been acquired in a merger to be paid the "fair value" of its shares, as determined by a court, instead of accepting the merger consideration.[2]

While an acquirer would not typically have a right to terminate the merger agreement if the dissenting-shareholders condition is not satisfied, a failure of the dissenting-shareholders condition would excuse the acquirer's obligation to consummate the merger and, accordingly, provide the acquirer certain optionality with respect to the transaction.

For example, the acquirer could decide to increase the amount of merger consideration to be paid to all shareholders and thereby convince some or all of the dissenting shareholders to revoke their exercise of appraisal rights and accept the increased merger consideration. Raising the amount of merger consideration to an acceptable level is generally not accomplished in a vacuum and could involve negotiating with one or more dissenting shareholders.

Alternatively, the acquirer could decide not to increase the merger consideration and instead waive the dissenting-shareholders condition, close the transaction and deal with dissenting shareholders after the closing. Under this scenario, the acquirer would likely expect that at least some of the dissenting shareholders would withdraw their appraisal demands after the closing and accept the merger consideration instead of holding out for a settlement or litigating to a final court decision.

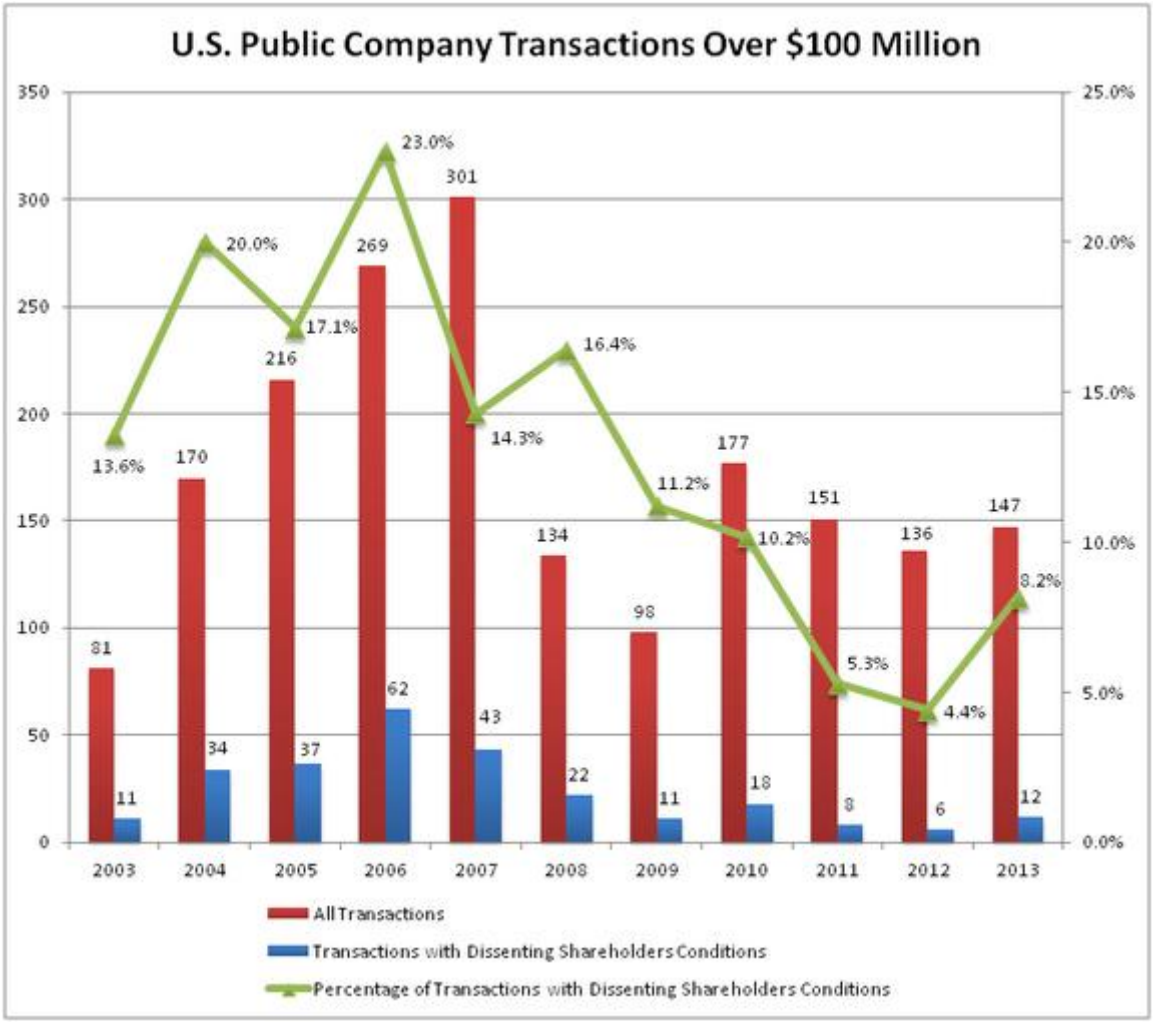
Finally, if the acquirer did not waive a failed dissenting-shareholders condition, the merger agreement would eventually be terminated by one of the parties for failure of the merger to be consummated prior to an outside date provided for in the merger agreement or, alternatively, by mutual consent of the parties.

Recent developments in shareholders' emphasis on maximizing the value of appraisal rights and changes to the Delaware corporate statute may lead acquirers to increasingly seek and obtain dissenting-shareholders conditions in their transactions.

Historical Use of Dissenting-Shareholders Conditions

Set forth below is a chart analyzing U.S. public company transactions for which definitive agreements were signed during the 11-year period ending Dec. 31, 2013, and that had transaction values exceeding $100 million.[3] For each year, the chart sets forth the total number of such transactions and the total

number of such transactions that contained dissenting-shareholders conditions. Using these figures, the percentage of transactions that contained dissenting-shareholders conditions is plotted for each year.



The chart reveals several interesting data points. Overall, 14 percent of the transactions covered in the chart contained dissenting-shareholders conditions.[4] Also, while 2007 had the highest number of deals, it had the second-lowest percentage of transactions with dissenting-shareholders conditions during the six-year period leading up to the 2008 banking crisis (2003 through 2008).[5]

In addition, each of the years since the 2008 banking crisis (2009 through 2013) had a lower percentage of transactions with dissenting-shareholders conditions than any of the six years leading up to the 2008 banking crisis. While the percentage of transactions with dissenting-shareholders conditions decreased each year after 2008, it began to increase in 2013. In particular, the underlying data show that 11.8 percent of the transactions from the second half of 2013 contained dissenting-shareholders conditions.

Of course, dissenting-shareholders conditions are not all the same. Significantly, the threshold percentage of outstanding shares in excess of which the exercise of appraisal rights will result in the failure of the condition varies widely, ranging from an acquirer-friendly 2 percent threshold in some deals to a high of 50 percent in one of the reviewed transactions.[6]

Commonly used thresholds for dissenting-shareholders conditions are 5 percent, 10 percent and 15

percent of the corporation's outstanding shares, with 48.5 percent of the reviewed transactions containing a dissenting-shareholders condition specifying a 10 percent threshold.

The Threat of Appraisal Litigation

The notable increase in the volume and sophistication of appraisal litigation will likely encourage more acquirers to consider whether to demand the leverage provided by a dissenting-shareholders condition.

Appraisal litigation differs from the more routine shareholder class action suits that accompany nearly all public deals. Appraisal litigation does not seek to prohibit or restrain the transaction; instead, the closing of the transaction is necessary for an appraisal rights claim to proceed.

Appraisal litigation takes place after the closing of a transaction, and, if not settled, often requires years to be finally adjudicated. For Delaware corporations, dissenting stockholders often hold meaningful positions in the shares for which they exercise appraisal rights because, as a general matter, the stockholders and the corporation each bear their own attorneys' fees in the appraisal litigation.

While a judge's determination of the fair value of a stock can be an amount higher or lower than the merger consideration, in Delaware, the fair value exceeds the merger price in approximately 85 percent of cases litigated to decision.

In addition, under Delaware law, judgments of fair value determined by a court are subject to interest at a rate of 5 percent above the Federal Reserve discount rate, which accrues from the date of the merger through the date of payment of the judgment by the acquirer. As such, in the current interest rate environment, even a fair-value determination that is less than the merger price can result in an attractive return for a dissenting stockholder.

Recognizing the incentives to bring appraisal litigation, shareholder activists, hedge funds and arbitrageurs have become more active in exercising and publicly promoting the exercise of appraisal rights. For example, in 2013, in response to the announced $24.4 billion leveraged buyout of Dell Inc., Carl Icahn exercised his appraisal rights and led a high-profile, public campaign to encourage other stockholders to do the same. Icahn only dropped his demand for appraisal after the buyout group increased the merger consideration payable to all Dell stockholders.

In addition, certain hedge funds now include appraisal litigation in their investment strategy. As an example, Merion Investment Management LP is a hedge fund that, along with its affiliates, has been active in appraisal litigation in connection with public mergers going back to at least 2011, and most recently, in the buyouts of BMC Software Inc. and Dole Food Co. Inc. in 2013 and Lender Processing Services Inc. in 2014.

For Delaware corporations, this strategy is facilitated by the fact that, in most cases, stakes can be purchased and appraisal rights exercised up until the taking of the vote to adopt the merger agreement at the stockholders meeting, giving potential investors the benefit of additional time following the announcement of a deal to assess market conditions and stockholder sentiment prior to deciding whether to establish a stake and seek appraisal.

For example, on Dec. 19, 2013, the same day that the stockholders of Lender Processing Services Inc. voted to adopt its merger agreement with Fidelity National Financial Inc., Merion Investment Management reported in a Schedule 13G filing beneficial ownership of 6.6 percent of the outstanding

shares of Lender Processing Services. The merger closed on Jan. 2, 2014. On Feb. 6, 2014, Merion Investment Management's affiliates filed an appraisal action in Delaware Chancery Court for their shares of Lender Processing Services.

Finally, appraisal rights trusts have begun to be organized for the sole purpose of allowing investors to participate in appraisal rights claims for individual deals. These trusts provide additional flexibility to potential investors by allowing fund managers to buy, sell or hold "appraised value rights" investments through a trust that will manage the appraisal litigation while providing investors liquidity opportunities in the event they do not want to wait until a final resolution of the appraisal litigation.

Changes in Delaware Law

Amendments made to the Delaware corporate statute in 2013 now make it possible for an acquirer to include a dissenting-shareholders condition in a tender offer or exchange offer transaction, a closing condition that was previously unavailable.

Last year, the Delaware General Corporation Law was amended to add Section 251(h), which provides that, subject to certain conditions, upon completion of a tender or exchange offer for any and all outstanding target corporation shares, the offeror can effect a second-step merger to squeeze out the remaining minority stockholders without having to obtain approval at a stockholders meeting if, immediately following the consummation of the offer, the offeror owns at least the number of shares that would be required to adopt the merger agreement at a meeting of the corporation's stockholders in accordance with applicable law and the corporation's charter.

Before Section 251(h) came into effect, nearly all recent merger agreements for transactions using a two-step structure contained the grant of an option (a "top-up option") by the target to the offeror pursuant to which, upon the successful completion of the offer, the offeror had the right to purchase such number of newly issued shares from the target to result in the offeror owning the minimum percentage of outstanding shares (90 percent in Delaware) necessary for the offeror to effect a second-step short-form merger to squeeze out all remaining minority shareholders of the target without the necessity of a shareholder vote.

The top-up option allowed the offeror to close the second-step merger as early as the same day that the shares were purchased in the offer, thereby dispensing with the need to hold a shareholders meeting to approve the merger agreement, which approval might require two or more months to obtain.

Accordingly, Section 251(h) was added to the Delaware merger statute to simplify a process[7] that was for the most part already being streamlined by the use of top-up options. Given the speed and ease with which a transaction under Section 251(h) can be effected, many practitioners expect that use of the two-step structure for acquisitions of Delaware public corporations will increase.

Prior to the enactment of Section 251(h), however, two-step transactions did not have dissenting-shareholders conditions because appraisal rights are not available in connection with a tender or exchange offer. A stockholder that wanted to demand appraisal of its shares in connection with a two-step transaction had to wait for the offer to be consummated and then, if a short-form merger was effected without a stockholder vote[8] (as would be the case if a top-up option were exercised or the offeror purchased in the offer a sufficient number of outstanding shares), the stockholder would exercise its appraisal rights after the second-step merger was effected.

Accordingly, in two-step transactions, acquirers historically have not had the ability to negotiate dissenting-shareholders conditions into merger agreements, even when such conditions would otherwise be available if the transactions had been structured as one-step mergers.[9]

The newly enacted Section 251(h) allows an acquirer to incorporate a dissenting-shareholders condition into its tender or exchange offer for shares of a Delaware corporation because, as part of the implementation of Section 251(h) into the Delaware merger statute, the Delaware appraisal statute was also changed to provide that in connection with a merger under Section 251(h), a corporation can send the required notice of the availability of appraisal rights to its stockholders prior to the closing of the offer.

In response to these changes, Delaware corporations have begun using the recommendation statement on Schedule 14D-9 filed in connection with the offer to notify their stockholders of the availability of appraisal rights and requiring that all demands for appraisal be made no later than as of the time that the first-step offer is consummated.

By allowing two-step transactions to be structured so that appraisal rights are required to be exercised by no later than the consummation of the offer, the Delaware statute has made it possible for an acquirer to include a dissenting-shareholders condition as a condition to its obligation to consummate its offer, which is, effectively, a condition to doing the entire deal.

Accordingly, one of the significant effects of Section 251(h) on the two-step structure is that dissenting-shareholders conditions can now be used for a class of transactions for which they were previously unavailable. In fact, an acquirer has already included a dissenting-shareholders condition in a tender offer.

The transaction between Harris Interactive Inc. and Nielsen Holdings NV announced on Nov. 25, 2013, was structured as a tender offer followed by a Section 251(h) merger, and the obligation of Nielsen Holdings to consummate the tender offer is subject to appraisal rights being demanded for no more than 13 percent of the outstanding shares of Harris Interactive.[10]

Conclusion

With market participants increasingly employing creative approaches to put more focus on appraisal litigation and recent changes in Delaware law affording new opportunities to parties in two-step transactions, acquirers will likely give more consideration to whether they demand and obtain dissenting-shareholders conditions in public company M&A transactions going forward.

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[1] Occasionally, the dissenting-shareholders condition will also be for the benefit of the target. For example, the transaction between CapitalSource Inc. and PacWest Bancorp announced in 2013

contained a dissenting-shareholders condition that was for the benefit of both parties.

[2] Appraisal rights vary from state to state and are sometimes available for extraordinary transactions other than mergers.

[3] Analysis based upon data available from FactSet MergerMetrics.

[4] The data also show that dissenting-shareholders conditions are not only used in small- or middle-market transactions, they have also been included in large-cap deals, including Procter & Gamble's 2005 acquisition of The
Gillette Co., a transaction that was valued at approximately $53.5 billion. In that all-stock transaction, appraisal rights were not available to Gillette stockholders because it was a Delaware corporation; however, because Procter & Gamble was an Ohio corporation, its shareholders were entitled to appraisal rights. The dissenting-shareholders condition for Procter & Gamble's benefit had a 5 percent threshold.

[5] Interestingly, for the year that had the lowest number of deals (2003), the percentage of transactions that contained dissenting-shareholders conditions was only 0.7 percent less than the percentage of transactions that contained dissenting-shareholders conditions in the year with the highest number of deals (2007).

[6] The 2010 transaction between Mariner Energy Inc. and Apache Corp. had a dissenting-shareholders condition with a 50 percent threshold.

[7] Section 251(h) eliminates certain issues that have complicated the use of top-up options. For example, some target corporations might not have enough authorized and unissued shares to ensure that if an acquirer purchased the minimum number of outstanding shares necessary to close the offer, a sufficient number of shares could be issued under the top-up option to permit the acquirer to effect a short-form second-step merger. While practitioners devised solutions to this particular problem that added complication and expense to transactions, Section 251(h) provides a more elegant and cheaper solution.

[8] In Delaware, if a stockholders meeting would be required to obtain approval of the merger agreement in order to effect the second-step merger, a stockholder would be required to demand appraisal prior to the vote to adopt the merger agreement at the stockholders meeting; however, an offeror would not seek a dissenting-shareholders condition in connection with this "long-form" second-step merger because, among other reasons, the offeror would already hold a majority of the shares of the target as a result of the consummation of the offer and it would seek to squeeze out the minority stockholders regardless of the number of shares for which appraisal rights are exercised. As such, before the enactment of Section 251(h), dissenting-shareholders conditions were not available for two-step transactions.

[9] The Delaware statute provides that appraisal rights are available for all mergers under Section 251(h), while appraisal rights are not available for one-step mergers in all-stock transactions.

[10] The Section 251(h) merger for the Harris Interactive/Nielsen Holdings transaction was completed on February 3, 2014.