

Delaware Appraisal Actions: When Does It Make Sense to Prepay?

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In response to the growing practice of “appraisal arbitrage,” in 2016 Delaware’s General Assembly amended the state’s appraisal statute, Section 262 of the Delaware General Corporation Law. The amendment to Section 262(h) granted corporations the option to “prepay” appraisal claimants an amount of the corporation’s choosing in order to stop the accrual of interest. While corporations now have the option to pay, should they? Whether, when and how much to prepay is a complex and nuanced judgment that will vary depending on the particular facts and circumstances of a case.

Background

Prior to the amendment, corporations in an appraisal action had no mechanism (absent settlement of the litigation) to stop the accrual of interest. A corporation could only prepay if the appraisal claimant or claimants agreed. In *Huff Fund Investment Partnership v. CKx, Inc.*, the Delaware Court of Chancery noted that “despite the potential utility of such an approach,” forcing an appraisal petitioner to accept prepayment from a corporation “would be incompatible with the General Assembly’s intent.”

Two years after that 2014 decision, the General Assembly changed the law. Corporations now have the option to prepay any amount at any time to eligible appraisal claimants.

Considerations When Deciding Whether to Prepay

Just because corporations are now allowed to unilaterally prepay an amount to appraisal claimants does not mean that they should. Each appraisal litigation, and the facts and circumstances confronting the respondent corporation (or its successor in interest), is unique. When determining whether to prepay, it is important to consider the following:

1. Prepaying Will Stop the Accrual of Interest and Eliminate Interest Uncertainty

As discussed above, prepaying cuts off an appraisal claimant’s ability to accrue interest on the amount prepaid from the date the payment is made. Under Delaware law, petitioners are awarded the Delaware legal rate of interest, which is 5 percent over the Federal Reserve discount rate and generally compounded quarterly. Because appraisal actions can, on average, take two to three years to litigate through trial, the amount of prejudgment interest can end up being significant. As an example, where adjudicated fair value of the corporation implies that the appraisal claimants’ shares are worth \$25 million, more than \$5,000 a day in interest will have accrued on that award. Over the course of two years, the total prejudgment interest on the \$25 million would be nearly \$3.7 million.

This example also highlights two important (and not immediately apparent) risks in appraisal litigation. First, one cannot know with certainty the “principal” on which the interest rate will accrue until the end of trial. Because of the length of time necessary to litigate appraisal cases, the total amount of interest owed can vary significantly based upon even small differences in the fair value determination. Second, the Delaware legal rate floats with the Federal Reserve

discount rate, so the statutory rate of interest can change throughout the course of the litigation. Moreover, the Federal Reserve has hiked interest rates four times over the past year and has suggested that additional increases may follow in 2018. So, while interest generally accrues daily at the prevailing rate (and thus corporations are not paying a higher rate for interest accrued prior to an interest rate hike), it is possible that the interest rate at the beginning of the litigation may not be the rate by the time the action concludes. Of course, the principle applies to both the risk of an interest rate hike as well as the potential for a drop in rates, and corporations may wish to monitor the statements coming from the government to assess their rate exposure.

2. What Is the Corporation's Cost of Capital and Natural Cash Flow Cycle?

When appraisal claimants perfect their appraisal rights, they are making a decision to forgo the transaction consideration in favor of the Court of Chancery's determination of fair value. Once the transaction closes, they are no longer stockholders of the target corporation. Instead, they become unsecured creditors.¹ In theory, Delaware law compensates appraisal claimants for the risk incurred through the determination of the final appraisal decision by awarding prejudgment interest at the legal rate.

In addition, there is no requirement that the corporation keep escrowed for the duration of litigation the portion of the transaction consideration allocated to appraisal claimants. Nothing in the statute forbids a corporation from using that capital while the litigation is proceeding. Thus, corporations face context-specific considerations in determining whether and when to prepay.

Among other considerations, when determining whether to prepay some amount in an appraisal litigation, a corporation may wish to consider how its cost of capital for unsecured

debt compares to the Delaware legal rate of interest. If the corporation's cost of capital is higher, it may wish to reclaim the undistributed merger proceeds from the transfer agent and redeploy them elsewhere within the company. If it is lower, that may factor in favor of prepaying.²

Perhaps just as important is determining when to make a prepayment. As noted above, Section 262(h) grants corporations flexibility in determining both the specific timing and amount of any prepayment. Companies in the ordinary course of their business can experience times in which they are flush with cash and times in which they are "cash poor." These cycles occur naturally in certain industries. Companies that experience these cycles may be able to time their prepayment to coincide with a period in the cycle in which they can make the prepayment with cash on hand. This saves the company the added cost of having to borrow funds just to make the prepayment.

Absent prepayment, a corporation will be required to satisfy the entire appraisal judgment (plus interest) all at once, and it may have to do so when it is naturally cash poor. The Court of Chancery does not issue opinions to coincide with the natural cash cycles of the respondent company in the litigation. Thus, the timing of the court's decision could force a corporation to borrow to cover the cost of the appraisal judgment. Prepaying allows the company to reduce some of that risk.

3. Prepaying May 'Fund the Litigation' and Reduce Settlement Leverage

Whereas the chief reward for prepaying can be perceived as the elimination of interest accrual, one of the primary concerns for corporations is whether they will be effectively "funding the litigation" for the appraisal claimants. By forgoing the transaction consideration, appraisal claimants are forced to use alternative sources of capital

¹ See, e.g., *In re Orchard Enters., Inc. Stockholder Litig.* (Del. Ch. Aug. 22, 2014) ("Appraisal claimants forgo the merger consideration, opting through the appraisal election to become unsecured creditors of the respondent corporation for the duration of the appraisal proceeding.").

² Corporations may also choose to keep the undistributed capital with the transfer agent for a variety of reasons. By doing so, a company can mitigate the "cash flow" timing risk described in this section.

(or alternative fee arrangements with counsel) to cover the costs of the litigation. Over several years, appraisal litigation can be expensive for both sides. Thus, prepaying can be seen as providing capital the appraisal petitioner can use to prosecute the appraisal case.

Prepaying may also reduce a corporation's settlement leverage. In appraisal actions, the costs incurred early in the case (usually through the conclusion of fact discovery) are very one-sided because the bulk of discovery in nearly all appraisal actions comes from the corporation or third parties that the corporation has agreed to indemnify. One of the few pieces of settlement leverage that corporations possess is that petitioners have voluntarily agreed to forgo the transaction consideration and the appraisal claimant is without that capital for the duration of the litigation.

In addition, some commentators have argued that recent cases from the Delaware Supreme Court and the Court of Chancery have diluted the appeal of "appraisal arbitrage." If true, prepaying any amount may also reduce a corporation's settlement leverage by reducing the amount of money an appraisal claimant has in what it may now view as an undesirable investment. Likewise, prepaying can be seen as reducing settlement leverage by lowering the risk and downside exposure a petitioner would otherwise face during the pendency of a lengthy appraisal litigation.

4. There Is No Statutory 'Refund' Mechanism

Finally, when determining whether and how much to prepay, it is important to note that Section 262(h) does not contain a provision requiring an appraisal claimant to "refund" the difference if the Court of Chancery ultimately determines that fair value is less than what the corporation prepaid. The Court of Chancery has yet to expressly consider whether a target corporation that "overpaid" its prepayment may recoup the difference under other legal theories (for example, unjust enrichment) and what the terms of such recoupment would be, if ordered. For example, would the corporation receive interest on the amount of overpayment?

One way a corporation can mitigate these concerns is by negotiating with appraisal petitioners a "refund" provision as part of a larger stipulation governing the terms of the prepayment. Although Section 262(h) does not require such a stipulation, many petitioners are amenable to it in practice. In cases where a stipulation cannot be reached, the parties may have to raise these issues directly with the Court of Chancery, which results in additional litigation effort and cost.