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Clarifying Appraisal Rights in Complicated Transactions

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Editor's note: Gail Weinstein is senior counsel, Steven Epstein and Warren S. de Wied are partners at Fried, Frank, Harris, Shriver & Jacobson LLP. This post is based on a Fried Frank memorandum by Ms. Weinstein, Mr. Epstein, Mr. de Wied, Philip Richter, Andrea Gede-Lange, and Maxwell Yim. This post is part of the Delaware law series; links to other posts in the series are available here.

Related research from the Program on Corporate Governance includes Using the Deal Price for Determining "Fair Value" in Appraisal Proceedings by Guhan Subramanian (discussed on the Forum here).

In *City of North Miami Beach Genl. Employees' Retirement Plan v. Dr Pepper Snapple Group, Inc.* (June 1, 2018), the Court of Chancery held that appraisal rights are not available to the stockholders of Dr Pepper in connection with a transaction structure (involving a reverse triangular merger and a special cash dividend to the target stockholders) which will result in the sale of control of the company.

Key Points

- **The court confirmed that the Delaware appraisal statute does not bestow appraisal rights simply upon a sale of control—rather, appraisal rights are available only under certain statutorily-specified types of transactions.**
- **The court indicated that it will not "look through" a transaction structure to the "underlying economic and practical effect" in order to grant appraisal rights when they are not otherwise specifically provided under a "plain reading" of the statute.**
- **The court held that appraisal rights are not available to Dr Pepper's stockholders because Dr Pepper (as a *parent* of the entity actually merging) is not a "constituent corporation" in the merger. The court held that, in addition, appraisal rights are not available because the Dr Pepper stockholders are not relinquishing their shares in connection with the transaction.**
- **The *Dr Pepper* structure may be used in conflicted controlle r transactions, but, in our view, it is unlikely that it would be more broadly used for the purpose of eliminating appraisal rights (as discussed below under "Practice Points").**

Background

Keurig Green Mountain, Inc. has agreed to purchase Dr Pepper Snapple Group, Inc. in a $21 billion merger. The proposed transaction is structured so that Keurig will become an indirect wholly-owned subsidiary of Dr Pepper through a reverse triangular merger; Dr Pepper stockholders will receive $103.75 per share in a special cash dividend; Dr Pepper stockholders will retain their shares of Dr Pepper, which post-merger will represent 13% of the shares of the combined company; and the indirect owners of Keurig (a privately held company) will receive shares of Dr Pepper which will represent 87% of the shares of the combined company. The Dr Pepper stockholders are not being asked to approve the merger (which combines a merger subsidiary of Dr Pepper with the parent of Keurig), but are being asked to approve two related transactions necessary for the merger to occur (the special cash dividend and a charter amendment to authorize more shares to be issued in the merger). Dr Pepper's preliminary proxy statement states that Dr Pepper stockholders will not have appraisal rights.

The plaintiff brought suit contending that, based on the "economic reality" of the transaction—*i.e.*, that Dr Pepper's stockholders are giving up 100% of control of Dr Pepper in exchange for cash and a 13% equity stub in the combined entity—the stockholders should be entitled to appraisal rights. Chancellor Bouchard ruled against the plaintiffs based on a "plain reading" of the appraisal statute and a disinclination "to judicially rewrite the statute" to achieve a result based on the "underlying economic and practical effect" of the transaction structure.

Discussion

The structure of the transaction. The transaction is structured as a reverse triangular merger, where the parent corporation (Dr Pepper) causes its wholly-owned subsidiary (Merger Sub) to merge with and into the private corporation that indirectly owns Keurig (Maple Parent), with Maple Parent surviving the transaction as a wholly-owned subsidiary of Dr Pepper. Each share of Merger Sub common stock will be converted into one share of the surviving corporation (Maple Parent); and each share of Maple Parent common stock will be converted into the right to receive shares of newly issue Dr Pepper common stock determined pursuant to the exchange ratio set forth in the merger agreement. Before closing of the merger, Maple Parent will declare a $9 billion cash dividend to Dr Pepper, and Dr Pepper plans to declare a special cash dividend of $103.75 per share to its stockholders which will be funded largely from the $9 billion dividend it will receive from Maple Parent. Immediately after the effective time of the merger, the equity holders of Maple Parent immediately before the effective time will own 87% of Dr Pepper's common stock; the public stockholders of Dr Pepper will retain their shares, which will represent 13% of Dr Pepper's common stock; and the controlling stockholder of Maple Parent (JAB Holdings) will be Dr Pepper's controlling stockholder.

The requirements of the appraisal statute. DGCL § 262(b) provides that "[a]ppraisal rights shall be available for the shares of any class or series of stock of a *constituent corporation* in a merger or consolidation…." The statute also contemplates—under the exception in § 262(b)(2) to the "market-out" exception in § 262(b)(1)—that stockholders will only be entitled to appraisal if they are required to accept certain specified types of consideration for their shares in a merger or consolidation. The court held that the Dr Pepper stockholders are not entitled to appraisal rights because (i) Dr Pepper is not a "constituent corporation" and (ii) the Dr Pepper stockholders are not required to accept *any* type of consideration for their Dr Pepper shares (as they are retaining those shares).

The meaning of "constituent corporation" in the appraisal statute. The court observed that the term "constituent corporation" is not defined in the DGCL. The court concluded that use of the term in various sections of the DGCL "clearly imply," and "authorities…uniformly support," that the term "plainly means only an entity that actually is being merged or combined with another entity in a merger or consolidation and thus does *not* include a parent of such entities." Applying this definition, the court held: "[I]t is clear that the 'constituent corporations' in the Merger are Maple Parent and Merger Sub and that Dr Pepper is not a constituent corporation in the Merger."

The "economic reality" of the transaction. The plaintiffs urged the court to focus on "the structure and economic reality of this deal," and to "cut through the form of the Merger and Special Dividend and consider the 'give' and 'get' of the transaction: Dr Pepper's stockholders are giving up 100% control of Dr Pepper in exchange for $103.75 per share in cash and a 13% equity stub in the post-Merger entity."

The plaintiffs contended that the deal was, in actuality, a "straightforward corporate merger" for cash consideration, but was structured differently for the purpose of denying target stockholders appraisal rights. The plaintiffs contended that the transaction resembles the transaction in *Louisiana Muni. Police Employees' Retirement Syst. v. Crawford* (2014). There, the challenged transaction involved CVS acquiring Caremark through a reverse triangular merger, with a CVS subsidiary being merged with and into Caremark and, after the merger, Caremark stockholders owning 45.5% of the combined entity via a newly held CVS/Caremark stock and receiving a special cash dividend of $6 per share payable by Caremark for the stock they previously held. The court found in that situation that the special cash dividend was "fundamentally" cash consideration paid to Caremark stockholders on behalf of CVS that did not have independent legal significance from the merger. The court thus held that Caremark stockholders had appraisal rights because they were being forced to accept cash consideration in the merger.

The *Dr Pepper* plaintiffs argued that it is even more compelling to provide appraisal rights to the Dr Pepper stockholders than it was to provide them to the Caremark stockholders because, in *Dr Pepper*, the stockholders are almost entirely cashed out and left with "nominal equity in a controlled entity." The court found this argument "not persuasive." The court emphasized that "[t]he form of the transaction in *Crawford* neatly [met] Section 262's requirements—Caremark was a constituent corporation in the merger with a CVS subsidiary, and Caremark's stockholders were required to exchange their Caremark shares for CVS/Caremark shares and cash consideration." By contrast, the court stated, Dr Pepper is *not* a constituent corporation in the merger and the Dr Pepper stockholders are *not* being required to relinquish their shares. The court concluded: "In essence, the plaintiffs are asking the court to disregard the express terms of the appraisal statute to surmise the underlying economic and practical effect of the Merger and the Special Dividend. It would be inappropriate for me to judicially rewrite the statute to achieve this result…." The court added in a footnote: "[I]f the Legislature is concerned about the lack of availability of appraisal rights for this type of transaction, the appropriate recourse is to amend the statute."

Practice Points

The decision raises the issue whether the Dr Pepper structure (*i.e.*, a reverse triangular merger with a cash dividend) is likely to be utilized in other transactions to avoid appraisal rights for the target stockholders. The plaintiffs in *Dr Pepper* contended that denying the Dr Pepper stockholders appraisal rights "would encourage other companies to imitate [Dr Pepper's]

contortionist moves" to deprive minority stockholders of appraisal rights. In a footnote, the court characterized this contention as "overstated." The court observed that the structure "is no secret" and was employed nearly a decade ago in a merger involving Allscripts Healthcare Solutions, Inc. and Msys plc.

In our view, it is unlikely that the structure would be broadly used solely for the purpose of avoiding appraisal rights. We note that the structure involves the disadvantages of complexity (making it potentially impractical in any competitive bidding situation) and leaving an equity stub in the hands of the target public stockholders (a result that acquirors typically disfavor). Moreover, generally (with an exception possibly in the case of conflicted controller transactions), it would be inadvisable to structure a transaction based primarily on avoiding appraisal rights—given that appraisal claims are made only in a relatively low (and recently declining) percentage of transactions, that appraisal awards significantly above the deal price are made only rarely (recently, even more rarely), and that appraisal awards at (or even below) the deal price have been increasingly prevalent recently. As the appraisal risk continues to be meaningful in conflicted controller transactions, the *Dr Pepper* structure might be attractive in these situations if the controller is prepared to leave some of the equity of the target company with the sellers. We note that the public equity stub could be eliminated through a reverse stock split following completion of the merger—however, there would be an issue whether that additional step might (i) convince the court to view the structure as an impermissible contrivance to avoid appraisal (thus leading to a different result than in *Dr Pepper*) and/or (ii) raise fiduciary issues and affect the court's review of the transaction under the "entire fairness" standard.

We note that there are other, less complex structures that could be considered which could render appraisal rights inapplicable (although, of course, any novel structure could raise business and practical issues and prompt legal challenges)—see **here** "Structuring Possibilities that Could be Considered to Eliminate or Reduce Appraisal Risk," in our previous Fried Frank M&A/PE Briefing, *Appraisal Practice Points Post*-SWS.