

Delaware's Corporate Appraisal Statute and Fair Value Standard

by Bradley W. Voss, Esq.

Abstract

Delaware's corporation law provides stockholders of Delaware corporations with the right to receive the judicially determined "fair value" of their shares in connection with certain corporate transactions. This article provides an overview of the Delaware appraisal statute and appraisal actions brought under it, as well as the standards generally employed by the Delaware Court of Chancery to determine fair value. It also summarizes the rules governing the allocation of fees and costs in an appraisal action, as well as the calculation of post-merger interest on the fair value award.

Appraisal Rights

Section 262 of the Delaware General Corporation law (8 Del. C. §262, or the "Appraisal Statute") provides a procedure for the judicial determination of the fair value of shares owned by a stockholder of a Delaware corporation who dissents from a corporate transaction covered by the statute, such as a cash-out merger.¹ When a merger gives rise to appraisal rights, the corporation must notify² the stockholders of record³ of their right to seek appraisal. If a stockholder elects to pursue appraisal, then that stockholder must not vote to approve the proposed merger, must formally demand appraisal, and must strictly comply with the Appraisal Statute's other requirements. Because failing to comply with the technical requirements of the Appraisal Statute will result in a loss of appraisal rights, a person considering appraisal should seek assistance from qualified legal counsel.

A stockholder who has demanded appraisal may, upon written request, obtain from the surviving corporation a statement indicating the aggregate number of shares not voted in favor of the transaction, the aggregate number of shares that have demanded appraisal, and the number of holders of such shares.⁴ A dissenting stock-

holder who has not commenced an appraisal action (or joined in one as a named party) may withdraw his or her demand for appraisal within sixty days of the effective date of the merger and receive the merger consideration.

Appraisal Action

The appraisal action typically is initiated when a dissenting stockholder files a verified petition in the Delaware Court of Chancery, which has jurisdiction over appraisal actions. An appraisal petition must be filed within 120 days after the effective date of the merger. The right to appraisal is limited to stockholders who have properly dissented from the merger and who have otherwise satisfied the statutory prerequisites. Appraisal actions under Delaware law resemble a class action in some respects, as the filing of an appraisal petition by one dissenting stockholder will be deemed to have been filed on behalf of all dissenters.⁵ Thus, a dissenting stockholder may choose to rely on other dissenters to prosecute the appraisal action because the judicial determination of fair value is binding on all dissenters in the "appraisal class," regardless of whether they prosecuted the appraisal action. It is not unusual for appraisal petitions to be filed by several stockholders in connection with a transaction. In that situation, the Court typically has consolidated the actions so that the company's fair value may be determined in a single trial.⁶

The Court must determine which shares are entitled to appraisal, as well as the fair value of those shares. The fair value may be determined to be more than, equal to, or less than the amount offered by the transaction giving rise to the appraisal right. Because of the importance of testimony from valuation experts in determining fair value, the appraisal action has been referred to as a "battle of experts."⁷ However, the Court is not required to accept a valuation offered by a party's expert. While rarely exercised, the Court has the power to appoint a neutral expert to assist the Court with valuation, and may even appoint a special appraisal master.⁸ The Court frequently rejects the experts' valuation opinions, in

¹ See 8 Del. C. § 262(b)-(c) (2007). The term "merger" is used herein to refer generically to such a qualifying transaction.

² See §262(d). Where the transaction triggering appraisal rights is to be submitted for approval at a meeting of stockholders, the corporation must notify record date stockholders of the availability of appraisal rights no less than twenty days prior to the meeting. If the transaction is a short-form merger under § 253, or is approved by written consent of stockholders pursuant to § 228, then the corporation must notify stockholders within ten days of the effective date of the transaction.

³ A person owning shares held of record by another person (such as a broker or fiduciary) will need to act promptly to cause the record holder to timely perfect appraisal rights.

⁴ See § 262(e).

⁵ See *In re PNB Holding Co. S'holders Litig.*, 2006 WL 2403999, at *2 (Del. Ch. Aug. 18, 2006).

⁶ E.g., *Highfields Capital, Ltd. v. AXA Fin., Inc.*, 939 A.2d 34, 42 (Del. Ch. 2007) (consolidating action and appointing lead counsel for all petitioners, who offered a single expert valuation opinion).

⁷ *Rapid-American Corp. v. Harris*, 603 A.2d 796, 802 (Del. 1992).

⁸ See 10 Del. C. § 372(a) (power to appoint masters); *Gonsalves v. Straight Arrow Publishers, Inc.*, 2002 Del. Ch. LEXIS 105 (Sept. 10, 2002) (appointing neutral expert to perform valuation).

whole or in part, and undertakes its own valuation based on the evidence offered by the parties.⁹ Such evidence may be developed through the discovery procedures ordinarily permitted in civil litigation.

Fair Value Standard

Under the Appraisal Statute, fair value is determined as of the effective date of the merger, “exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation.”¹⁰ In other words, the company must be valued on a “stand-alone” basis, based on the “operative reality” of the company at the time of the merger, without the benefit of any anticipated synergies.¹¹

A dissenting stockholder is entitled to receive “a proportionate share of fair value in the going concern.”¹² The Court must determine the fair value of the corporation as a whole and award the dissenting stockholder his or her proportionate share of that value.¹³ Fair value, therefore, should not reflect any discount for minority shares, and values derived from the trading price of minority shares may need to be adjusted to reverse any inherent discount.¹⁴ In light of these principles, the fair value of shares for purposes of the Appraisal Statute might differ from the fair market value of the same shares.¹⁵

In assessing fair value, the Court may consider “all relevant factors” that might affect valuation.¹⁶ Typically, the evidentiary record will include both publicly available and internal financial information from the time period leading up to the merger. However, certain post-merger information might be considered relevant as well.¹⁷ While the Court recognizes that value determinations are impossible to make with anything approaching complete confidence, it must determine a specific fair value in each case.¹⁸

⁹ See *In re U.S. Cellular Operating Co.*, 2005 WL 43994, at *10 (Del. Ch. Jan. 6, 2005).

¹⁰ *Doft & Co. v. Travelocity.com, Inc.*, 2004 WL 1152338, at *5 (Del. Ch. May 20, 2004) (citing 8 Del. C. § 262(h)).

¹¹ See *Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Group, Ltd.*, 847 A.2d 340, 356 (Del. Ch. 2004); *M.G. Bancorp., Inc. v. LeBeau*, 737 A.2d 513, 525 (Del. 1999).

¹² *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 298 (Del. 1996) (citations omitted).

¹³ *Cavalier Oil Corp. v. Harnett*, 1988 WL 15816, at *9 (Del. Ch. Feb. 22, 1988).

¹⁴ See, e.g., *Andaloro v. PFPC Worldwide, Inc.*, 2005 WL 2045640, at *18 (Del. Ch. Aug. 19, 2005); *Travelocity.com*, 2004 WL 1152338, at *11.

¹⁵ See *Agranoff v. Miller*, 791 A.2d 880, 888 (Del. Ch. 2001); *Union Ill. 1995 Inv. Ltd. P'ship*, 847 A.2d 340, 356.

¹⁶ 8 Del. C. § 262(h).

¹⁷ See *Konfirst v. Willow CSN, Inc.*, C.A. No. 1737-N, ltr. op. at 3 (Del. Ch. Sept. 7, 2006).

¹⁸ See *Prescott Group Small Cap, L.P. v. Coleman Co.*, 2004 WL 2059515, at *31 (Del. Ch. Sept. 8, 2004).

Valuation Techniques

To determine fair value, the Court may rely upon any valuation methodology that is generally accepted in the financial community and otherwise admissible in court.¹⁹ Given this flexibility, the selection of valuation techniques to be applied in a given case is a highly fact-specific determination. Nonetheless, the discounted cash flow (“DCF”) technique is perhaps the most commonly relied upon method of valuation in appraisal actions.

Discounted Cash Flow

The Court gives the DCF methodology “great, and sometimes even exclusive, weight,” when it can be used responsibly.²⁰ The Court will consider the future prospects of the company based on all information “known or susceptible of proof as of the date of the merger.”²¹ The Court generally favors using management’s pre-merger projections if they are available and reliable.²² However, post-merger evidence may be admissible to show that “plans in effect at the time of the merger have born fruition.”²³

The discount rate often is among the most heavily disputed issues in an appraisal action. The Court frequently has determined the present value of anticipated cash flows using the corporation’s weighted average cost of capital.²⁴ The Court has utilized the Capital Asset Pricing Model on several occasions to determine the corporation’s cost of equity.²⁵ Some recent decisions have recognized the appropriateness of using the corporation’s target capital structure for purposes of weighting the cost of equity and debt to calculate the discount rate.²⁶

To calculate the terminal value of the corporation, the Court has used perpetuity growth models as well as exit multiples.²⁷ In certain circumstances, the Court has deemed it appropriate to use a “three stage” DCF where a period of transitional growth is assumed to occur between the period of management’s forecasts and the

¹⁹ See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713 (Del. 1983). This article does not attempt to describe all valuation methods that have been used in appraisal actions in the Court of Chancery.

²⁰ *Andaloro*, 2005 WL 2045640, at *9.

²¹ *Weinberger*, 457 A.2d at 713.

²² *Cede & Co. v. Technicolor, Inc.*, 2003 WL 23700218, at *7 (Del. Ch. July 9, 2004), *rev'd in part*, 875 A.2d 602 (Del. 2005), *superseded*, 884 A.2d 26 (Del. 2005); *Travelocity.com, Inc.*, 2004 WL 1152338, at *5.

²³ *Cede & Co. v. Technicolor, Inc.*, 758 A.2d 485, 499 (Del. 2000).

²⁴ See *Cede & Co. v. JRC Acquisition Corp.*, 2004 WL 286963, at *7 (Del. Ch. Feb. 10, 2004).

²⁵ E.g., *Hintmann v. Fred Weber, Inc.*, 1998 WL 83052, at *3 (Del. Ch. Feb. 17, 1998).

²⁶ *Andaloro*, 2005 WL 2045640, at *13–14; *Henke v. Trilithic, Inc.*, 2005 WL 2899677 (Del. Ch. Oct. 28, 2005), *modified*, 2005 WL 3578094, at *9 (Del. Ch. Dec. 20, 2005).

²⁷ *Henke*, 2005 WL 2899677, at *10; *In re U.S. Cellular Operating Co.*, 2005 WL 43994, at *17.

perpetuity growth period.²⁸ The Court has questioned the use of an exit multiple where that multiple is derived from trades of minority shares and, consequently, might reflect an imbedded minority discount that is proscribed by the fair value standard.²⁹

Merger Price

Recently, the Court has given substantial weight to the merger price as an indicator of fair value where “the transaction giving rise to the appraisal resulted from an arm’s-length process between two independent parties . . . [and] no structural impediments existed that might materially distort ‘the crucible of objective market reality.’”³⁰ In a case where the agreed-upon merger consideration was the result of an auction process, the Court determined that the merger price was the best indicator of the fair value of the shares being appraised.³¹ It may be necessary, however, to exclude the amount of shared synergies reflected in the merger price to determine fair value “exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation,” as required by the Appraisal Statute.³²

Other Methodologies

The Court sometimes will consider other valuation methodologies, including both comparable companies and comparable transactions analyses. The Court has recognized, however, that such comparables analyses are limited by the similarity between the subject company/transaction and the companies/transactions used for comparison. Citing the “Law of One Price,” the Court has concluded that a broad range of values resulting from a comparables analysis may be too unreliable to be given significant weight.³³

Although the Court may conclude that one analysis is the most reliable method to assess fair value, it may nonetheless find other methodologies to be helpful. For instance, where the Court believed that other methods were informative but not as reliable as the DCF analysis, it calculated fair value by blending the results of the various methodologies, while giving greatest weight (75%) to the DCF results.³⁴ Other methodologies or

indicia of value may also serve as a “reasonableness check” on the Court’s or a party’s valuation conclusions.³⁵

Fees and Costs

Absent extraordinary circumstances, each party bears the expense of its own attorneys and experts. However, consistent with the quasi-class nature of the appraisal action, the Appraisal Statute permits the Court to apportion the expenses of a stockholder pro rata against all shares participating in the appraisal.³⁶ This mechanism can help prevent a stockholder from incurring disproportionate expense for prosecuting an appraisal action where multiple stockholders stand to benefit.

Post-Merger Interest

A recent amendment to the Appraisal Statute provides that a stockholder is generally entitled to interest on the fair value of his or her shares from the effective date of the merger through the date of payment of the appraisal award. Interest accrues at a rate equal to 5% over the Federal Reserve discount rate as established from time to time during the period between the effective date of the merger and payment, compounded quarterly.³⁷ This change eliminates the need for experts to opine on the appropriate method for calculating the interest component of the Court’s appraisal award. It also reduces the risk and burden of the appraisal action for petitioners, especially in light of the fact that such a proceeding may last years.

Conclusion

A corporate appraisal action in the Delaware Court of Chancery typically is a “battle of experts” over the fair value of a company at the time of a merger. While the Court may rely on any generally accepted valuation methodology, the Court frequently uses the discounted cash flow method to determine going concern value. Recently, however, the Court has looked to the merger consideration, less synergistic elements of the sale price, as a market-based proxy for fair value. Accordingly, one should be prepared to explain why fair value exceeds the merger consideration in the context of an arms-length merger where the company has been shopped and there are no obstacles to a topping bid. Finally, recent changes to the method of calculating post-merger interest have reduced the risk of an appraisal action to the petitioner, but he or she still bears the ultimate risk that the Court’s appraisal award will be less than the consideration offered by the merger.

²⁸ *Andaloro*, 2005 WL 2045640, at *12; *Prescott Group Small Cap, L.P.*, 2004 WL 2059515, at *29.

²⁹ *See In re PNB Holding Co. S’holders Litig.*, 2006 WL 2403999, at *31.

³⁰ *Highfields Capital*, 939 A.2d at 42.

³¹ *Union Ill. 1995 Inv. Ltd. P’ship*, 847 A.2d at 357.

³² 8 *Del. C.* § 262(h); *see also Highfields Capital*, 939 A.2d at 60–61.

³³ *JRC Acquisition Corp.*, 2004 WL 286963, at *3 n.28; *see also U.S. Cellular*, 2005 WL 43994, at *17.

³⁴ *Andaloro*, 2005 WL 2045640, at *20.

³⁵ *See Highfields Capital*, 939 A.2d at 52 n.49. As noted above, this article does not attempt to provide an exhaustive list of valuation methodologies considered or utilized by the Delaware Court of Chancery.

³⁶ *See* 8 *Del. C.* § 262(j).

³⁷ *See* § 262(h).

Bradley W. Voss, Esq. is with Potter Anderson & Corroon LLP, located in Wilmington, Delaware. Mr. Voss can be reached at (302) 984-6023. The views expressed herein are solely those of the author, and do not necessarily represent the views of the firm or its clients. This article should not be relied on for legal advice, especially in light of the complexity of the Appraisal Statute and the decisional law interpreting it. This article may be deemed to constitute attorney advertising.