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Delaware Chancery Court Once Again Defers to Merger Price in Appraisal Proceeding (Part 2)

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In the first article of this two-part series, we discussed recent decisions by the Delaware Chancery Court in which the court relied primarily or solely on the merger price to determine the fair value of appraised stock. In each of the cases where the court deferred to the merger price, however, other valuation methods, such as the discounted cash flow (DCF) method and comparables-based analyses, proved to be unreliable or weak. This led deal lawyers to question whether the court would defer to the merger price where alternative methods of valuation were found to be reliable.

The court answered this question in the affirmative in its December 2016 decision in *Merion Capital L.P. v. Lender Processing Services, Inc.*, giving exclusive weight to the merger price in determining the fair value of the appraised stock despite the existence of reliable management projections that supported a meaningful DCF analysis. 2016 WL 7324170, at *33, 2016 BL 418466 (Del. Ch. Dec. 16, 2016). The decision thus serves as another useful precedent for respondents urging the court to defer to the merger price and as a forewarning to appraisal arbitrageurs seeking for the court to use reliable, but perhaps optimistic, management projections to support a DCF valuation above the merger price.

Background of the Case

Lender Processing Services, Inc. ("LPS" or the "Company") was a provider of integrated technology products, data and services to the mortgage lending industry. *Id.* at *1. Following the recent economic recession, LPS experienced a large but temporary boost in revenues and faced lawsuits from stockholders and the government concerning its loan protocols. *Id.* at *2. In 2010, LPS began receiving unsolicited acquisition proposals, and, in response, its board hired a financial advisor to assist it in evaluating the offers and contacting additional potential financial sponsors and strategic acquirers. *Id.* LPS entered into confidentiality agreements with multiple potential bidders, and negotiations with one bidding group proceeded until the summer of 2012, when price discussions reached an impasse based in large part on the Company's legal risk stemming from the ongoing lawsuits. *Id.* at *2-3.

In late 2012, LPS hired a management consulting firm to evaluate the Company's core business and "pressure test[]" each element of management's five-year projections. *Id.* at *3-4. Then, in early 2013, LPS announced that it had settled many of the lawsuits concerning its loan protocols, which sparked a "flurry" of indications of interest and acquisition proposals from potential buyers. *Id.* at *4-5. The LPS board deferred consideration of the offers until its consultants had completed their review. *Id.* at *5. The results of the consultants' work indicated that LPS faced "[m]arket headwinds" that would cause significant reductions in revenues in future years. *Id.* In light of the consultants' findings and the many indications of interest received by the Company, the LPS board decided to reinitiate a sale process. *Id.* at *5-7. The Company's bankers reached out to several parties, both financial and strategic, and LPS entered into confidentiality agreements with multiple potential bidders. *Id.* at *7-8. Ultimately, only one party, Fidelity National Financial, Inc. (Fidelity), made a bid for the entire Company. *Id.* at *8-9. Following negotiations, LPS signed a merger agreement with Fidelity that provided for LPS stockholders to receive a mix of cash and stock that, at the time of signing, was valued at $33.25 per LPS share, and that included a one-way collar to protect against a decline in the value of Fidelity's stock. *Id.* at *9.

The merger agreement contained a go-shop provision, but none of the potential buyers contacted during the go-shop period submitted an indication of interest, let alone a topping bid, and the merger closed. *Id.* at *10-11. Fidelity's stock price increased between the signing of the merger agreement and the closing of the transaction, resulting in an increase in the value of the consideration paid to LPS stockholders to $37.14. *Id.* at *11. After closing, LPS

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performed below its base-case projections. *Id.* at *11-12.

Appraisal arbitrageurs Merion Capital L.P. and Merion Capital II L.P. filed a petition in the Delaware Chancery Court seeking a determination of the fair value of their shares in LPS. *Id.* at *12. Following trial, the court issued a memorandum opinion in which it found that the fair value of LPS stock was $37.14 per share as of the date of the merger. *Id.* at *1, 33.

The Court's Analysis

The court began its analysis by evaluating the initial merger consideration of $33.25 per share, finding it ''a reliable indicator of the Company's fair value at the time of the signing of the Merger Agreement.'' *Id.* at *16. The court determined that the Company's sale process created ''meaningful competition'' among a mixture of potential strategic and financial buyers without any signs of favoritism toward any particular buyer. *Id.* at *16-23. The court rejected the petitioners' contention that the sale process could not be trusted to reflect fair value because it led only to a single bid, explaining that Fidelity was unaware that its competitors had dropped out of the process, perceived the process to remain open to competition, and faced a credible threat that LPS would reject its offers and continue operating the business on a stand-alone basis. *Id.* at *18-19. The court also noted that the record indicated that, ''even at $33.25 per share, the deal price included a portion of the synergies that Fidelity . . . hoped to achieve from the transaction.'' *Id.* at *23.

The court next evaluated whether the final merger consideration of $37.14 was a reliable indicator of fair value as of the closing of the merger, concluding that it likely exceeded fair value in light of the Company's declining performance between the signing of the merger agreement and the closing of the transaction, the appreciation in the merger consideration due to the operation of the collar, and the ''extensive evidence indicating that the Initial Merger Consideration included a portion of the value that Fidelity . . . expected to generate from synergies.'' *Id.* at *23-26.

Finally, the court addressed the parties' competing DCF valuations and the weight, if any, to give to a DCF analysis. *Id.* at *26-33. After resolving disagreements between the parties' experts regarding various inputs, the court undertook a DCF analysis that returned an estimated fair value of $38.67 per share of LPS stock. *Id.* at *29. The court then proceeded to compare the merger price to its DCF valuation, determining to give 100 percent weight to the merger price despite having performed a ''meaningful DCF analysis'' using ''a reliable set of projections'' prepared by Company management. *Id.* at *29-33. In deciding to rely entirely on the merger price, the court took comfort that its own DCF analysis returned a value within 3 percent of the merger price but lamented that small adjustments to the assumptions in the DCF model would cause large changes in the resulting valuation. *Id.* at *33. Thus, although both methods produced reliable indicators of fair value, the court determined to rely entirely on the merger price, which did not depend on any assumptions. *Id.*

The court also considered adjusting its determination of fair value to discount any synergies reflected in the merger price. *Id.* Noting that there was ''extensive evidence'' in the record indicating that the merger price included combinatorial synergies, the court explained that such a discount would have been appropriate had the argument been timely raised by the respondent. *Id.* at *26, 33. However, the court declined to adjust its fair value determination to deduct for synergies because the respondent's expert had disclaimed any attempt to quantify their value, and because the respondent had not raised the issue until post-trial briefing. *Id.* at *33.

Accordingly, the court concluded that the fair value of LPS stock as of the closing date of the merger was $37.14 per share, representing the value of the final merger consideration received by LPS stockholders. *Id.*

Conclusion

The *Merion Capital L.P. v. Lender Processing Services, Inc.* decision demonstrates that the court will afford exclusive weight to the merger price not only where alternative valuation methods prove unreliable, but also where the merger price is simply the best indicator of fair value. The decision thus recognizes that a DCF valuation, which can fluctuate significantly based on small changes in its underlying inputs and assumptions, inherently is less reliable evidence of fair value than a price an arm's-length buyer is willing to pay in the market.

Significantly, a sale process need not be perfect in order for the court to choose the merger price over a value generated by a DCF analysis. For example, the LPS board had relationships with Fidelity and the private equity firm it teamed with on the transaction, and the two companies even shared a common corporate campus. *Id.* at *22-23. The Company's financial advisors also failed to timely disclose to the LPS board that they had lucrative relationships with Fidelity's private equity partner. *Id.* at *10. Further, the LPS board did not follow its bankers' recommended sale process, failing to delay its approach to Fidelity as had been suggested in order to increase the ''competitive tension'' in the process. *Id.* at *7. The court found that none of these issues compromised the sale process as ''an effective means of price discovery.'' *Id.* at *16.

Additionally, respondents in appraisal proceedings should take note that the court's willingness to rely on the merger price over other indicators of fair value increases the importance of timely raising the argument that the court should deduct the value of merger-related synergies from the deal price, developing evidence of such synergies during the discovery phase of the litigation, and then proving through fact and expert testimony at trial the value of those synergies reflected in the deal price. In its opinion, the court observed that there was ''extensive evidence'' indicating that the merger consideration included a portion of the value of synergies, *id.* at *26, but declined to make a deduction for them because the respondent ''litigated on the theory that the Final Merger Consideration represented the 'maximum fair value' '' of LPS stock and the respondent's expert did not opine ''on the quantum of synergies or [] propose an adjustment to the merger price.'' *Id.* at *33. Accordingly, respondents in appraisal proceedings should be ready to prove not only that the deal price is the best evidence of fair value, but also that such price includes an amount attributable to merger-related synergies that should be deducted from a fair value determination based on such price.

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