2017 Year in Review:

The State of Appraisal in the Delaware Courts

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INTRODUCTION

The first Tulane Corporate Law Institute was held in December 1988. Any discussion of appraisals then would surely have included the difficulty and frustrations encountered by law-trained judges in determining "fair value." In that respect, not much has changed in thirty years. In the recent *Ancestry* appraisal case, for example, Vice Chancellor Glasscock voiced his frustration and noted that the real "burden" of proof in appraisal cases fell upon the judge.

But what has changed in thirty years is the emergence of the Delaware Courts' emphatic reliance on deal price, at least in conflict-free, public company deals. Appraisal cases from the mid-to-late 1990s suggest no presumption in favor of deal price, relying instead on an "objective" evaluation of each side's valuation inputs and methodologies. The Supreme Court's recent decisions in *Dell* and *DFC Global* now leave no doubt that deal and market price *matter*. That is surely a welcome development for some, even if 30 years in the making. It is for that reason, in this year of appraisal, we have devoted this publication to the significant developments in the law of appraisal. We hope you will find the articles and summaries useful and informative.

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Delaware Supreme Court Reverses Court of Chancery's Dell Appraisal Decision: "Deal Price Deserved Heavy, If Not Dispositive, Weight"

Deal Points, Winter 2018

Christopher N. Kelly, Ryan M. Murphy and Jay G. Stirling

On December 14, 2017, in a much-anticipated decision in the appeal from the Court of Chancery's above-deal price appraisal of Dell Inc.'s stock following a buyout of the company by its founder and a private equity firm, the Delaware Supreme Court, sitting *en banc*, held that the Court of Chancery, which had given no weight to the $13.75 per share deal price and instead used exclusively a discounted cash flow analysis to find that the fair value of Dell was $17.62 per share (or 28 percent higher than the deal price),[1] "erred in not assigning any mathematical weight to the deal price" because "the record as distilled by the trial court suggest[ed] that the deal price deserved heavy, if not dispositive, weight."[2]

The Supreme Court's *Dell* opinion caps a noteworthy seven years of appraisal jurisprudence since its 2010 decision in *Golden Telecom Inc. v. Global GT LP*,[3] in which the Court rejected the respondent corporation's request that Delaware courts employ "a standard requiring conclusive or, in the alternative, presumptive deference to the merger price in an appraisal proceeding," at least where that price resulted from a "pristine, unchallenged transactional process."[4] While the Delaware courts historically had relied on the deal price as evidence of fair value of appraised stock when the sale process leading to the transaction was robust and free of fiduciary misconduct,[5] following *Golden Telecom*, opportunistic hedge funds increasingly utilized statutory appraisal proceedings as a form of investment strategy, purchasing substantial blocks of shares in publicly traded target corporations after the announcement of mergers for the purpose of pursuing appraisal and attempting to secure fair value awards significantly above the deal price by proffering litigation-driven DCF valuations employing aspirational sale-case financial projections and questionable assumptions made or altered by their experts. But, notwithstanding this rise of "appraisal arbitrage," which resulted in a significant increase in appraisal litigation in the Court of Chancery, the court largely continued the practice of relying on the deal price as the primary or sole evidence of fair value of appraised stock when that price resulted from arm's-length negotiations in an open market.[6]

In *DFC Global Corp. v. Muirfield Value Partners, L.P.*,[7] an appeal from one of the few decisions in which the Court of Chancery did not rely heavily on the deal price for its fair value determination, the Supreme Court reversed the trial court's above-deal price appraisal award, holding that it abused its discretion by giving only one-third weight to the deal price despite finding that the sale process was robust and free of conflicts of interest.[8] In so holding, the Supreme Court confirmed that the Court of Chancery should give significant (if not dispositive) weight to the deal price in such circumstances.[9] The Supreme Court explained that, "[a]lthough there is no presumption in favor of the deal price, under the conditions found by the Court of Chancery, economic principles suggest that the best evidence of fair value was the deal price, as it resulted from an open process, informed by robust public information, and easy access

to deeper, non-public information, in which many parties with an incentive to make a profit had a chance to bid."[10] Pertinently, the Court rejected the trial court's two principal reasons for not affording more weight to the deal price—the facts that the company "faced increasing regulatory constraints that could not be priced by equity market participants" and that "the prevailing buyer was a private equity rather than strategic buyer"[11]—explaining that there was no evidence in the record to suggest that market participants could not price the regulatory risk facing the company and that "all disciplined buyers, both strategic and financial, have internal rates of return that they expect in exchange for taking on the large risk of a merger" and a buyer's focus "on hitting its internal rate of return has no rational connection to whether the price it pays as a result of a competitive process is a fair one."[12] In remanding the case, the Supreme Court instructed the trial court to "reassess the weight [it] chooses to afford various factors potentially relevant to fair value," and suggested that it should "conclude that [its] findings regarding the competitive process leading to the transaction" support the determination "that the deal price was the most reliable indication of fair value."[13]

Against this backdrop, the Supreme Court issued its *Dell* decision. By way of background, dissenting stockholders sought appraisal following a management buyout at $13.75 per share led by Dell's founder and affiliates of a private equity firm.[14] The Court of Chancery observed that the buyout resulted from a thorough sale process that "easily would sail through if reviewed under enhanced scrutiny."[15] An independent special committee negotiated with the buyout group, and evaluated alternatives through pre-signing and post-signing market checks that yielded rival bids from other PE firms.[16] Throughout the process, Dell's founder expressed willingness to partner with any of the bidders and to supply as much of his own equity as needed to complete a going-private transaction.[17]

Nevertheless, the Court of Chancery found that a confluence of factors justified assigning no weight to the deal price, and instead relied exclusively on its own DCF analysis, which resulted in a fair value of $17.62 per share.[18] The Vice Chancellor concluded that both the market and the sale process did not reflect the company's intrinsic value: the market was too focused on Dell's short-term prospects and the participation of only financial bidders in the process resulted in a deal priced to clear internal rate of return hurdles.[19] The court also found that factors "endemic" to MBO go-shops cast doubt on the reliability of the deal price,[20] because rival bidders could be discouraged from making topping bids due to perception that management had an informational advantage, fear that there was "no realistic pathway to success," or risk of overpaying for the company (*i.e.,* the putative "winner's curse").[21]

In its appeal, Dell argued, and the Supreme Court agreed, that the Court of Chancery's "decision to give no weight to any market-based measure of fair value [ran] counter to its own factual findings."[22] The evidence pointed to an efficient, rather than myopic, market for Dell shares.[23] The Supreme Court observed that the lack of strategic bidders during the pre- and post-signing phases suggested that the deal price was not too low: if the deal price had substantially undervalued the company, then strategic competitors would have had strong incentives to bid.[24] Furthermore, there was nothing in the trial record to suggest the presence of the putative features of MBOs that theoretically could undermine the reliability of deal price as evidence of fair value: Dell mitigated any informational asymmetry between the buyout group and other bidders by providing go-shop participants extensive due diligence and access to Dell's founder;[25] and, contrary to any "winner's curse phenomenon," two rival bidders submitted competing proposals during the go-shop period.[26] In sum, the Court found "the market-based indicators of value—both Dell's stock price and deal price—have substantial probative value"[27] and "deserved heavy, if not dispositive, weight."[28]

* * *

Following *Dell, DFC Global,* and multiple decisions by the Court of Chancery deferring to the deal price, it is now clear that, in a statutory appraisal of stock of a public company acquired by merger, Delaware courts will give substantial, if not exclusive, weight to the deal price when it is derived through arm's-length negotiations in an open market. In effect, while the deal price is not presumed to be fair value as a matter of Delaware law, such a presumption may in fact exist in that context. *Dell* further suggests that the Delaware courts may in certain cases give heavy weight to a deal price in an interested-party buyout when the sale process is proven to have removed any putative insider advantage.

The Delaware courts' much greater willingness to give significant weight to the deal price and their expansion

of the transaction contexts in which such deference will be afforded likely will hasten the decline of appraisal arbitrage or at least require that hedge funds engaging in the practice select their litigation investments more cautiously. The primacy of deal price also increases the importance for respondent corporations to establish a record to support a deduction for merger-related synergies (assuming combinatorial synergies exist).

Additional takeaways from *Dell* (and *DFC Global*) include, among others, the following:

- **No Private Equity Carve-out.** Building on its decision in *DFC Global*, which emphatically rejected any hint of a "private equity carve out" or notion that PE buyouts inherently result in a deal price below fair value because financial sponsors use leveraged buyout pricing models designed to achieve a specific internal rate of return, the Supreme Court in *Dell* held that the lack of competition from a strategic bidder was not a credible basis for the trial court to disregard the deal price, stating that "if a company is one that no strategic buyer is interested in buying, it does not suggest a higher value, but a lower one,"[29] and that "[c]ompetition limited to private equity bidders does not foreclose the sale price reflecting fair value."[30] Of course, depending on the facts, a court may not give exclusive weight to a deal price in a PE buyout if, for example, the sale process favored financial sponsors or excluded strategic buyers for improper reasons.

- **Deal Price in MBOs Can Be Fair Value.** The Supreme Court in *Dell* similarly dispelled any suggestion that MBOs cannot result in a deal price reflective of fair value. In particular, the Court rejected multiple economic theories (*i.e.,* possible structural barriers in an MBO go-shop process, purported information asymmetries between management and third parties, and management's perceived value to the company) that arguably create an uneven playing field between management and potential third-party bidders that is endemic to MBOs and undermines the probative value of an MBO deal price as a general matter, concluding that, even assuming the theories had validity, the trial record did not support the application of any of these theoretical characteristics of MBOs.[31]

- **Implications for Appraisals of Controller Buyouts.** The Supreme Court's decision in *Dell* regarding MBOs potentially can be extrapolated to controlling stockholder buyouts, which arguably involve similar dynamics. *Dell* indicates that, when there is a robust process, any putative structural pricing inadequacies arguably associated with MBOs can be mitigated to allow deal price to be utilized as the best evidence of fair value. Consistent with recent Delaware cases, specifically *Kahn v. M & F Worldwide Corp.,*[32] which provides for business judgment rule deference and early dismissal in the fiduciary context, if procedural protections are established to eliminate any arguable controller advantage—namely, an independent special committee and approval by a majority of minority stockholders—then it is reasonable to posit that the deal price could be afforded significant (or dispositive) weight in an appraisal because the premise of a fair value determination is that it reflects what would be paid in an arm's-length deal.

- **Market Data as Indicia of Fair Value.** The Supreme Court held that the Court of Chancery lacked a valid basis to find a "valuation gap" between Dell's market price and its fundamental value. In so doing, the Supreme Court reaffirmed the efficient market hypothesis, which "teaches that the price produced by an efficient market is generally a more reliable assessment of fair value than the view of a single analyst, especially an expert witness who caters her valuation to the litigation imperatives of a well-heeled client."[33] Accordingly, absent evidence demonstrating inefficiencies in the market for the stock being appraised, the trading price and deal price likely will be afforded "substantial probative value" in the court's fair value determination.[34]

- **Increased Skepticism of DCF Valuations.** In *Dell,* having grown extremely frustrated with the "recurring problem" of appraisal petitioners proffering "highly paid, well-credentialed experts to produce DCF valuations" that dwarf the deal price, ignore the operative reality of the company, and reflect a price no buyer would pay, the Supreme Court indicated that law-trained judges "should be chary" about utilizing "less-than-surefire DCF analyses" because a DCF value inherently is less reliable evidence of fair value than a

price an arm's-length buyer is willing to pay in an open market and can fluctuate wildly based on small changes in its numerous underlying inputs and assumptions (in the case of *Dell*, for instance, there were "enormous valuation chasms caused by the over 1,100 variable inputs in the competing DCFs").[35]

- **Increased Reliance on Comparables-Based Valuation Methods.** Conversely, in *DFC Global*, the Court rejected the petitioners' cross-appeal challenging the trial court's decision to give weight to a comparable companies analysis,[36] suggesting (consistent with its reliance in both *DFC Global* and *Dell* on market-based indicia of value) that comparables-based valuation methods may regain traction. Though the Delaware courts sometimes have declined to rely on comparable companies and precedent transactions valuation analyses because of a perceived lack of sufficiently comparable peers, finance professionals rely every day on these approaches when making investment decisions with real money, and any potential error resulting from reliance on imperfect comparables may now be viewed by Delaware courts as less of a concern than the inherent flaws in "garbage in, garbage out" DCF analyses.

By confirming the primacy of deal price and other market evidence in appraisal proceedings challenging acquisitions of public companies that resulted from robust processes, the Delaware Supreme Court has provided a powerful incentive to transaction planners to engage in best practices when selling companies.[37] In so doing, the Court establishes the appropriate rule for Delaware law to produce the most value for all long-term target company stockholders rather than reward a limited number of short-term opportunists who rent-seek through appraisal.

Endnotes

1. *In re Appraisal of Dell Inc.*, 2016 WL 3186538, at *1 (Del. Ch. May 31, 2016) (*"Dell I"*).
2. *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd*, 2017 WL 6375829, at *16 (Del. Dec. 14, 2017) (*"Dell II"*).
3. 11 A.3d 214 (Del. 2010).
4. *Id.* at 217-18.
5. *See, e.g., Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Grp., Ltd.*, 847 A.2d 340 (Del. Ch. 2004).
6. *See, e.g., In re PetSmart, Inc.*, 2017 WL 2303599 (Del. Ch. May 26, 2017); *Merion Capital L.P. v. Lender Processing Servs., Inc.*, 2016 WL 7324170 (Del. Ch. Dec. 16, 2016); *Merion Capital LP v. BMC Software, Inc.*, 2015 WL 6164771 (Del. Ch. Oct. 21, 2015); *LongPath Capital, LLC v. Ramtron Int'l Corp.*, 2015 WL 4540443 (Del. Ch. June 30, 2015); *Merlin P'rs LP v. AutoInfo, Inc.*, 2015 WL 2069417 (Del. Ch. Apr. 30, 2015); *In re Appraisal of Ancestry.com, Inc.*, 2015 WL 399726 (Del. Ch. Jan. 30, 3015); *Huff Fund Inv. P'ship v. CKx, Inc.*, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013).
7. 172 A.3d 346 (Del. 2017).
8. *Id.* at 372.
9. *Id.* at 349.
10. *Id.*
11. *Id.* at 362.
12. *Id.* at 375.
13. *Id.* at 351.
14. *Dell II*, 2017 WL 6375829, at *1.
15. *Dell I*, 2016 WL 3186538, at *29.
16. *Dell II*, 2017 WL 6375829, at *4-7.
17. *Id.* at *5.
18. *Id.* at *11.
19. *Id.* at *10.
20. *Id.*
21. *Id.* at *10-11.
22. *Id.* at *12.
23. *Id.* at *17.
24. *Id.* at *21.
25. *Id.* at *23.
26. *Id.*
27. *Id.* at *25.
28. *Id.* at *16.
29. *Id.* at *21.
30. *Id.* at *25.
31. *Id.* at *23-25.
32. 88 A.3d 635 (Del. 2014).
33. *Dell II*, 2017 WL 6375829, at *16-17.
34. *Id.* at *25.
35. *Id.* at *25-28.
36. *DFC Global*, 172 A.3d at 386-88.
37. *See Dell II*, 2017 WL 6375829, at *28.

DFC Global: A Few Observations from Delaware

Deal Lawyers, September-October, 2017
T. Brad Davey

The Delaware Supreme Court recently issued its much-anticipated decision in *DFC Global v. Muirfield Value Partners* (Del. Sup.; 8/17), addressing, among other things, the weight the Court of Chancery should ascribe to the deal price in determining fair value. The decision is a warm, 85-page long embrace of efficient market theory—a concept with a checkered past in Delaware's jurisprudence.

While the Court declined to establish a bright-line rule requiring that the Court of Chancery defer to the deal price established through a robust, conflict-free sale process, it concluded the Court of Chancery abused its discretion in failing to accord the deal price greater weight under the circumstances of this case.

Because I know you all either have already read the decision or will do so soon, I will not summarize the decision, but rather offer a few observations about its practical import.

How Close is *DFC Global* to a "Bright Line" On the Deal Price?

If it's an abuse of discretion not to defer to the deal price, isn't there a bright-line rule requiring deference to the deal price? Though, perhaps a bit tongue-in-cheek, the question focuses on what, if any daylight, there is between the Court's decision and a bright-line rule in robust, conflict-free sale processes. I think the opinion provides a few hints.

First, by implication, the decision suggests that deal price may not be the most reliable evidence of fair value "where things like synergy gains or minority stockholder discounts are … contested." That suggestion does not reveal a great deal of daylight.

Where synergy gains are contested, assuming the deal price is the product of a robust, conflict free sale process, the Court of Chancery would likely start with the deal price and adjust for synergy gains. And, it will be the rare "conflict-free" sale process that gives rise to a situation in which minority stockholder discounts are contested.

Second, the decision's emphasis on efficient market theory suggests that the Court of Chancery could refuse to defer to the deal price that is the product of a robust, conflict-free sale process where the record demonstrated that the market had inadequate or inaccurate information.

Of course, that is a situation that most commonly arises in the context of private companies. So, here again, in the public company context, there does not appear to be a great deal of daylight between the Court's decision yesterday and a bright-line rule requiring deference to the deal price.

Decision Makes It Very Hard to Justify Departures from the Deal Price

Whatever might allow the Court of Chancery to depart from the deal price, two of the most common justifications don't work. Right? Or was that just a factual finding that the next petitioner can fix? Although the Delaware Courts have, in recent years, frequently deferred entirely to the deal price, there have been some notable exceptions.

Almost universally, those exceptions have involved some combination of the two justifications advanced by the Court of Chancery in *DFC Global* to depart from the deal price: the sale process coincided with a trough in the subject company's performance and the buyer was a financial sponsor seeking a particular internal rate of return on the acquisition. Here, the Supreme Court concluded it was an abuse of discretion for the Court to depart from the deal price for those reasons.

The careful readers will note that the Supreme Court held it was an abuse of discretion because those justifications lacked support in the record. But, the Supreme Court's analysis does not suggest that this was a failure of proof that a different petitioner can fix in the next appraisal proceeding.

Rather, the decision appears to conclude that the justifications are inconsistent with accepted economic theory. Thus, absent an evolution in accepted economic theory, it is difficult to see how these two justifications can be employed again as the basis for departing from the deal price.

"Abuse of Discretion" Standard Amplifies the *DFC Global* Holding

The standard—abuse of discretion—amplifies the holding. Abuse of discretion is an extremely deferential standard. Where applicable, the Supreme Court accepts the Court of Chancery's findings "if supported by the record and the product of an orderly and logical deductive process."

The Supreme Court cannot simply reverse because, on balance, it would have decided the case differently. Rather, it may only reverse findings "when they are clearly wrong and the doing of justice requires [the Court] to do so."

The Chancellor and Vice Chancellor now have a data point —it is an abuse of discretion to refuse to defer to the deal price in a robust, conflict-free sale process. To be sure, you have to add "under the circumstances of this particular case" to that data point. But, the abuse of discretion finding is an unmistakable signal to the Court of Chancery that deference to the deal price is a much safer approach than departing from it.

What is a "Robust" Sale Process?

What's "robust"? The sale process at issue in *DFC Global* was easy to categorize as robust. The company retained a financial advisor and, over the course of two years, contacted at least thirty-five financial sponsors and three strategics. But, something well short of that may suffice.

In *Longpath Capital v. Ramtron* (Del. Ch.; 6/15) for instance, the subject company engaged in a public search for a white knight to fend off a hostile takeover bid. Although the process did not result in competitive bidding, the Court of Chancery deemed it to be an effective market check. I think that analysis would be affirmed by the Supreme Court.

Indeed, given the reasoning of *DFC Global* and its full-throated endorsement of efficient market theory, I think there is a more than colorable argument that the Chancery Court should defer to a deal price that is the product of a single-bidder process with a passive post-signing market check, where the subject company has a deep base of public stockholders, with active trading, and the unaffected market price is consistent with the deal price.

What is a "Conflict Free" Sale Process?
There is a spectrum of conflicts. At the most-conflicted end, you have controller cash-outs. Similarly, you have a third-party sale of a controlled company, where the controller demands a premium.

At the other end, you have various management conflicts. The more serious being management-led buyouts and private equity deals with management roll-over. And, as some entrepreneurial plaintiffs' counsel might argue, management is conflicted in every sale transaction, because a sale—in addition to triggering various employment benefits—is the only means for them to diversify their risk as they typically have a disproportionate exposure to the subject company's equity.

Then Vice-Chancellor Strine appeared to recognize this conflict in *In re Lear Corp. S'holder Litig.* (Del. Ch.; 9/08), in which he required the company to disclose the CEO's desire to sell the company in order to diversify his holdings. But, absent unusual circumstances, the Court of Chancery consistently recognizes that the management equity aligns their interests with stockholders. So, in the coming months, we can expect to see the Delaware Courts endeavor to identify where on this spectrum of conflicts is a deal no-longer considered conflicted.

Must the Sale Process be Both Robust & Conflict Free?
Is it a conjunctive test? Must the sale process be robust AND conflict free? It's not clear. The thrust of the *DFC Global* decision, however, indicates that the Court of Chancery should be focused on whether the process, combined with other evidence, provided an effective means for price discovery. And, the *Dell* appeal will provide guidance on that front.

That case involved a management-led buyout; it was not conflict free. But, there was a very robust, competitive bidding process post-signing. While the Court of Chancery found that the bidding process could not cure the initial conflict because it was anchored by the original, conflicted deal price, the Supreme Court may very well find the presence of active, post-signing bidding provided more than adequate price discovery. Stay tuned.

A Shrinking Strike Zone for Appraisal Arbitrageurs
Undeniably, one consequence of *DFC Global* is a shrinking strike zone for appraisal arbitrageurs. At a Tulane conference a number of years ago, when the rise of appraisal arbitrage was the subject of considerable angina for transactional planners and defense-side litigators, Chief Justice Strine urged everyone to relax. Peering into his crystal ball, he predicted that appraisal arbitrageurs would not earn the types of returns that would justify the investment.

Of course, the Chief Justice has a particular advantage in predicting judicial outcomes and, in this instance, he appears to have been right. On balance, the arbitrageurs have had a rough run. Sure, there was *Dole Food* (Del. Ch.; 8/15), *Dell* (Del. Ch.; 5/16) and *DFC Global* (Del. Ch.; 8/15). But, those were followed by *PetSmart* (Del. Ch.; 5/17), *SWS* (Del. Ch.; 5/17) and *Clearwire* (Del. Ch.; 7/17). And, now *DFC Global* has been reversed.

These decisions suggest the appraisal remedy has its greatest utility in private company transactions, where the appraisal arbitrage model does not work, and in the substantially smaller universe of conflicted public company transactions. While it remains to be seen whether arbitrage funds will be able to continue to raise money for appraisal proceedings, from where I sit, it is becoming an increasingly unattractive investment.

Following *DFC Global*, where the sale process provides effective price discovery, it will likely be the rare case in which the Court of Chancery does not ascribe significant, if not full, weight to the deal price in determining the fair value of a public company.

Appraisal Practice Tips 1 Year after Prepayment Amendment

Law360, July 31, 2017

Berton W. Ashman, Christopher N. Kelly and Mathew A. Golden

Effective Aug. 1 of last year, Delaware's appraisal statute, Section 262 of the General Corporation Law of the State of Delaware (the DGCL), was amended in response to the recent rise of "appraisal arbitrage" to provide corporations acquired by merger or consolidation the option to prepay a sum of money to stockholders seeking appraisal and thereby limit the accrual of interest on the Court of Chancery's fair-value award. One year later, we review the impact of this amendment on appraisal litigation, offer practice considerations with respect to making prepayment, and question whether prepayment is counterproductive to the legislative purpose of the statutory amendment—discouraging appraisal arbitrage, or at least limiting its adverse effects—and detrimental to the acquisitive companies, financial sponsors and long-term stockholders who are the ultimate payers of the deal tax extracted by arbitrageurs. Further to the last of those topics, we propose a potential alternative to prepayment that, although untested, could be used by a respondent in an appraisal proceeding to argue that no interest should accrue on any fair-value award in favor of arbitrageurs.

The Prepayment Amendment

A significant concern of transaction planners in recent years has been the above-market interest rate on fair-value awards in appraisal proceedings. During a time when market interest rates have been near historic lows, Section 262(h) of the DGCL prescribes a presumptive approach for the award of interest, providing that, "[u]nless the Court in its discretion determines otherwise for good cause shown," interest is to be awarded at 5 percent over the Federal Reserve discount rate from the effective date of the merger through the date of payment of the judgment, compounded quarterly.

The 2016 amendment to Section 262(h) provides an option to a surviving corporation to prepay a sum of money to stockholders seeking appraisal, the amount of which may be determined in the sole discretion of the corporation, at any time prior to judgment, to avoid the need to pay subsequently accruing interest on the prepaid sum. Making or accepting prepayment does not give rise to any inference that the amount so prepaid is equal to, greater than or less than the fair value of the appraised shares. If any stockholder's entitlement to appraisal is contested by the corporation in good faith, the corporation may make prepayment only to those stockholders whose entitlement to appraisal is uncontested.

Prepayment Considerations and Practice Tips

The prepayment option now provided under Section 262(h) enables a surviving corporation to limit the accrual of interest on an appraisal award, but many factors should be considered when determining whether, how and the extent to which a corporation should make a prepayment. These include, among other considerations, the following:

- **Is There a Business Case for Prepayment?** For smaller amounts, the use of the prepayment option as an interest-expense reduction tool usually makes sound financial sense. Where, however, the prepayment would represent a substantial sum of money for the company, the case for prepayment will depend on, among other

things, the company's balance sheet, its cost of debt, and whether the funds can be deployed for business initiatives yielding returns in excess of the statutory interest rate. Thus, for a corporation with slow (or negative) growth, excess cash, and/or a low cost of debt, there generally is a strong business case for making a prepayment to stop the accrual of above-market interest. The same might not be said, however, for a fast-growing company with many business opportunities offering attractive investment returns, and/or one without a strong cash position or with a high cost of debt.

- **Will Prepayment Affect the Litigation?** While no legal inference may be drawn from the prepayment as to whether the amount prepaid represents the fair value of the appraised shares, prepayment may affect the litigation in other ways. Prepaid monies could be used by an appraisal petitioner to finance the litigation. Depending on the circumstances, prepayment could make it easier or more difficult to settle the litigation. For serial acquirers, prepayment could come with the risk that the money will be used to fund an arbitrage investment in the next target of the acquirer, leading to yet more appraisal litigation.

- **How Much to Prepay?** The answer to this question involves a careful balance of the risk of overpayment, on the one hand, with the desire to take full advantage of the statutory amendment and stop the accrual of above-market interest, on the other hand. An approximate range of prepayment amounts could be from the unaffected market price of the stock prior to the announcement of the merger (or perhaps 50 percent of the deal price if a privately held company), at the low end, to slightly less than or equal to the deal price, on the high end. The amount might depend on, among other things, the fair value the respondent corporation hopes ultimately to prove and the perceived strength of its case.

Once a surviving corporation has decided to make prepayment to stop the accrual of interest and determined the amount it intends to prepay, the corporation must then undertake to effectuate the prepayment. In this regard, it is important to note that, although Section 262(h) now provides an acquired corporation the right to make prepayment, the statute provides no guide as to how to make such a prepayment. Given that the statutory amendment went into effect only one year ago, there is as yet no standard or customary practice for prepayment in appraisal proceedings. Rather, each appraisal prepayment of which the authors are aware has been undertaken by a bespoke method suited for the particular demands of the case and the needs of the litigants.

For obvious reasons, it is advisable to execute a written agreement with the appraisal claimant to document the prepayment transaction, which may involve the payment of tens of millions or even hundreds of millions of dollars. Not only will such an agreement memorialize the terms and conditions of prepayment, but it will provide assurances to any relevant third-party agents, such as paying and transfer agents, some of whom have expressed concerns regarding prepayment mechanics in appraisal proceedings.

The following are a few of the key provisions in a written prepayment agreement:

- **Representations and Warranties as to the Proper Recipient of the Prepayment.** The language of the statutory amendment appears to contemplate that prepayment would be made to the stockholder of record, which is consistent with the manner in which merger consideration typically is paid; however, Cede & Co. (the record holder for most shares of publicly traded Delaware corporations) has indicated that any prepayment should be made not to it but rather directly to the beneficial owner of the appraised stock. In addition to the ambiguity in the statute, appraisal petitioners or claimants potentially can dispose of, pledge or assign their interests in the appraised shares. By documenting the prepayment in a written agreement, a surviving corporation can obtain representations and warranties from the petitioner or other appraisal claimant that it is the proper party entitled to prepayment and that it has not assigned or otherwise encumbered its stock. Similarly, it may make sense in certain cases for a respondent corporation to move the Court of Chancery pursuant to Section 262(g) to require the appraisal claimants to submit their stock certificates for notation thereon of the pendency of the appraisal proceedings, to eliminate any uncertainty as to the proper recipient of the prepayment funds.

- **Deduction From Future Appraisal Award of Prepayment Amount.** The statutory amendment provides a surviving corporation the right to make prepayment and addresses the resulting effect on the accrual of interest, but it does not expressly provide that the prepayment amount will be deducted from any future payment of the merger consideration or a fair-value award determined by the Court of Chancery. While this surely is implicit from the statutory amendment and its legislative history, and the Court of Chancery, as a court of equity, would be loath to permit an unjust double recovery, it remains advisable for a respondent corporation to obtain from the appraisal claimant an explicit forfeiture of the prepayment amount from any appraisal award.

- **Right to Recoupment of Overpayment if Fair Value is Less Than Prepayment Amount.** The statute as amended does not expressly provide for return of any prepaid funds if the Court of Chancery's fair value determination is lower than the prepaid amount. A written agreement, however, can provide for the recoupment of overpaid amounts. Appraisal petitioners have been willing to agree to such a clawback provision, perhaps because it may mean, for instance, that the corporation will make a larger prepayment. Prior stipulated orders agreed upon by appraisal litigants and approved by the court have included a recoupment right.

Impact on Appraisal Litigation to Date

One year has passed since the prepayment amendment took effect, but its efficacy in reducing appraisal litigation or otherwise easing the costs on acquirers associated with appraisal arbitrage largely remains to be seen. Insufficient post-amendment data exists to draw any firm conclusions regarding its effect on appraisal activity but, in the year following the Aug. 1, 2016, effective date of the amendment, appraisal filings have continued to increase. Since Aug. 1 of last year, 74 appraisal petitions have been filed in the Court of Chancery, challenging 39 different transactions. Chart 1

below compares these figures to those from the same period over previous years. A comparison of appraisal petitions filed in the first half of 2017 to the first halves of prior years is shown in Chart 2.

No matter the comparison period, the volume of appraisal actions continues to grow, notwithstanding the prepayment amendment. And, while the number of unique transactions subject to appraisal proceedings has declined compared to prior periods, that surely is due to the decline in merger and acquisition activity generally in 2017. Consequently, while the full impact of the prepayment option still remains to be seen, it is clear that the prepayment option has not deterred appraisal arbitrage to date. To the contrary, that appraisal litigation continues its upward trend despite the recent overall decline in M&A activity may suggest that, as discussed below, the prospect of prepayment is contributing to its continued rise.

The Free Capital Problem With Prepayment

The immediate interest-reducing benefit a respondent corporation can derive from prepayment is obvious and may very well override other considerations but, as suggested above, prepayment might also work against the legislative intent of the statutory amendment that authorizes it. To the extent a respondent corporation takes advantage of the amended statute, prepayment provides the appraisal arbitrageur with capital that would otherwise be tied up in the litigation and thus unproductive and at risk. The appraisal arbitrageur surely will put the prepaid funds to productive use elsewhere and may even invest them in its next appraisal arbitrage play, leading to yet more appraisal litigation—a disappointing outcome for companies and financial sponsors that routinely engage in corporate acquisitions. In all events, through receipt of a prepayment and deployment of those funds in other endeavors, the appraisal arbitrageur is able to increase its investment returns, hedge against risk, and reduce the impact of

Chart 1

Period	Appraisal Petitions Filed	Year-Over-Year Change	Deals Challenged	Year-Over-Year Change
Aug. 1, 2016-July 20, 2017	74	+40 percent	39	-10 percent
Aug. 1, 2015-July 31, 2016	53	+10 percent	43	+65 percent
Aug. 1, 2014-July 31, 2015	48	+2 percent	26	-19 percent
Aug. 1, 2013-July 31, 2014	47	+88 percent	32	+39 percent
Aug. 1, 2012-July 31, 2013	25	--	23	--

Chart 2

Period	Appraisal Petitions Filed	Year-Over-Year Change	Deals Challenged	Year-Over-Year Change
Jan. 1, 2017-June 30, 2017	35	+3 percent	18	-33 percent
Jan. 1, 2016-June 30, 2016	34	+3 percent	27	+42 percent
Jan. 1, 2015-June 30, 2015	33	+22 percent	19	+19 percent
Jan. 1, 2014-June 30, 2014	27	+80 percent	16	+23 percent
Jan. 1, 2013-June 30, 2013	15	--	13	--

an adverse fair-value award in the appraisal proceeding in which prepayment was made. Indeed, prepayment makes an appraisal arbitrage investment more auspicious by enabling an arbitrageur to retain all of the potential upside of the litigation (*i.e.,* a fair-value award in excess of the merger price) with little potential downside remaining because its capital (or much of it) has been returned (even with a contractual recoupment provision).

* * *

It remains too early to tell just how the prepayment option will affect appraisal arbitrage in general, but one can reasonably conclude that prepayment might serve to encourage, rather than discourage, the practice. Certainly, the number of new appraisal claims brought since the statutory amendment went into effect does not suggest a different conclusion. As many commentators predicted at the time the 2016 statutory amendments were adopted, the likely outcome is that prepayment will help to curb only the weaker claims, including primarily those brought solely for "interest arbitrage." The larger appraisal actions, where arbitrageurs have staked significant positions in a target company's shares, and where their investment is motivated by the potential of an award significantly in excess of the merger price, are unlikely to diminish and could instead increase if respondent corporations begin to prepay as a matter of course.

Accordingly, transaction planners are seeking alternative means to attempt to staunch the wave of appraisal arbitrage. The list of these possible alternatives is lengthy, and we propose one addition consistent with the topic of this article—a bylaw adopted by a board of directors in the context of a sale of the company aimed at barring statutory interest on a fair-value award in an appraisal proceeding brought by an arbitrageur.

Whether implemented while undertaking an auction, during sale negotiations with a prospective acquirer, or at the time of execution of the merger agreement, such a bylaw potentially would reduce the transaction's appeal to arbitrageurs and could be used by a target company board as a bargaining chip to extract additional merger consideration from an acquirer. While the validity and enforceability of such a bylaw surely would face challenge by appraisal arbitrageurs and ultimately be judged by the Delaware courts, such a bylaw arguably would be valid under Section 109(b) of the DGCL, which authorizes bylaws to "contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees."

Bylaws only are invalid under this statutory provision if they do not relate to any of these subjects, and a bylaw precluding an arbitrageur's recovery of statutory interest in an appraisal proceeding appears to relate to "the rights of [a target company's] stockholders [qua stockholders]." Nor does it appear that such a bylaw would run afoul of the DGCL, as Section 262(h) contemplates appraisal proceedings in which statutory interest will not be awarded by the court, expressly providing that the court may, in its discretion, determine not to award statutory interest for good cause shown. A bylaw precluding statutory interest for appraisal arbitrageurs, who did not own their stock prior to the announcement of the merger agreement and who acquired their stock notwithstanding notice of the bylaw, arguably would be "good cause" for the court not to award interest because such a bylaw constitutes part of the binding contract among the directors, officers and stockholders of the corporation and represents the target company board's good-faith business judgment to prefer the company's then-existing stockholders over opportunists who were not a part of the corporate enterprise and simply seek to extract a deal tax.

In sum, while prepayment likely does not deter (and may ultimately even encourage) appraisal arbitrage, it remains a useful and, therefore, attractive tool for individual companies to reduce the expense of appraisal litigation. Given the issues discussed above, however, repeat acquirers sensitive to the general state of appraisal litigation may be inclined to attempt alternative methods to reduce the interest expense on a fair-value award in a manner that does not provide free capital to their recurring arbitrageur adversaries. Time will tell if corporate counsel are able to devise effective deterrents for appraisal arbitrage. In the meantime, appraisal litigation continues to increase and acquirers and their counsel ought to understand the issues regarding whether and how to effect interest-reducing prepayments.

This article was originally published in the July 31, 2017 issue of Law360.

PetSmart is a Significant Loss for Appraisal Arbitrageurs

Law360, June 29, 2017

Christopher N. Kelly and Mathew A. Golden

Well-known to deal lawyers and their clients is the rise of "appraisal arbitrage." Under Delaware law, stockholders of a Delaware corporation acquired in a merger or consolidation generally may seek appraisal from the Delaware Court of Chancery of the "fair value" of their shares of stock, subject to certain conditions and exceptions outlined in Delaware's appraisal statute, Section 262 of the Delaware General Corporation Law. The legislative purpose behind that statute is to provide relief to stockholders dissenting from a merger on the basis of inadequacy of price—a statutory replacement for the common law rule that a single stockholder could block a merger. In the last few years, however, opportunistic hedge funds have exploited the statutory remedy as an investment strategy by buying stock in target companies after announcements of mergers for the purpose of seeking appraisal.

"Court of Chancery continues its trend of relying on the merger price as the best indicator of fair value of appraised stock"

That practice may very well subside as the Court of Chancery continues its trend of relying on the merger price as the best indicator of fair value of appraised stock and expands the transaction contexts in which such deference will be given. Indeed, the court's recent decision in *In re Appraisal of PetSmart Inc.,* 2017 WL 2303599 (Del. Ch. May 26, 2017), deferring to the deal price in a private equity buyout as to which arbitrageurs with nearly $1 billion in shares sought appraisal, may be viewed in the future as a harbinger of significant decline in appraisal arbitrage. Below we discuss this important decision and its impact on future appraisal proceedings.

Background of the Case

PetSmart Inc. is one of the largest retailers of pet products and services in North America. *Id.* at *3. Founded in 1987,

PetSmart experienced strong growth from 2000 until 2012 due largely to favorable dynamics in the pet industry. *Id.* at *3-4. However, in 2012, PetSmart's growth began to stall as it faced increasing competition and other headwinds. *Id.* at *4. Coupled with PetSmart's slowing growth, its management team struggled to accurately forecast the company's performance, even for the next quarter, and the difference between the projections and the company's actual performance oftentimes was significant. *Id.* In 2013 and early 2014, company management experienced substantial turnover, but the new officers were unable to improve the company's performance, and certain of their initiatives even caused additional difficulties for the company. *Id.* at *5. Following the company's poor financial results for the first quarter of 2014, several of PetSmart's stockholders (including its largest stockholder) voiced their frustration with the company's disappointing performance. *Id.*

Shortly thereafter, PetSmart's board of directors began to explore the company's strategic alternatives, and formed an ad hoc committee of independent directors to evaluate options that would increase stockholder value. *Id.* at *6. The board investigated various strategic options through June and early July 2014, when an activist hedge fund disclosed its acquisition of a large stake in the company and threatened a proxy fight if PetSmart were not sold. *Id.* at *6-7. After receiving this threat, the board retained J.P. Morgan Securities LLC to advise with respect to the company's strategic alternatives. *Id.* at *7.

The board then directed the company's management to prepare long-term projections. *Id.* at *8. Prior to this time, PetSmart management had never prepared long-term projections in the ordinary course of business; rather, it prepared one-year budgets that forecasted the company's quarterly performance for the upcoming year. *Id.* These short-term projections historically proved unreliable. *Id.* at *4. Under significant time constraints and intense pressure from the board "to put [the company's] best foot forward" in light of the discount prospective bidders potentially would apply, PetSmart management prepared multiple sets of progressively more ambitious long-term projections that reflected increasingly aspirational assumptions regarding the value of the company's growth and cost-cutting initiatives. *Id.* at *8-12. Ultimately, the board and management settled on a final set of projections (the "management projections") that approached "insan[ity]." *Id.* at *12.

In August 2014, the board determined to publicly announce that the company was exploring strategic alternatives, including a possible sale. *Id.* at *11. J.P. Morgan opened the auction process by contacting 27 potential bidders, comprised of a mixture of strategic and financial buyers. *Id.* at *12. Fifteen prospective bidders, all financial sponsors, signed nondisclosure agreements. *Id.* The board discussed with J.P. Morgan whether to formally invite PetSmart's primary competitor, Petco Animal Supplies Inc., to bid in the auction, but the board determined not to do so based on the risks that Petco would feign interest to gain access to PetSmart's confidential information and that a Petco-PetSmart merger would not obtain regulatory approval. *Id.* at *10, 12. The board, however, remained willing to engage with Petco if it expressed a serious indication of interest in a transaction. *Id.* at *12.

During the auction process, the board continued to consider alternatives to a sale and directed management to strengthen its plan to operate the company on a stand-alone basis. *Id.* at *13. However, the board determined it unlikely that the company could achieve the results forecasted in the management projections, and the company's performance stagnated and declined in the third quarter of 2014. *Id.* at *14. By December 2014, the public auction had narrowed to three financial bidding groups. *Id.* at *15. PetSmart solicited the bidders' best and final offers, and BC Partners Inc. submitted the highest bid at $83 per share. *Id.*

The board met on Dec. 13, 2014, to discuss the offers and the possibility of continuing to operate the company on a stand-alone basis. *Id.* Recognizing that the management projections posed significant execution risk, J.P. Morgan prepared two valuations of the company on a stand-alone basis, one based on the management projections, which returned a valuation of $78.25-$106.25 per share, and another based on sensitivity analyses it conducted, which returned a valuation of $65-$95.25 per share. *Id.* J.P. Morgan also delivered its fairness opinion that the $83 per share offered by BC Partners was fair from a financial point of view to the stockholders of the company. *Id.* After deliberating regarding the company's prospects on a stand-alone basis and the aggressiveness of the management projections, the board determined to accept BC Partners' offer to acquire the company for $83 per share, concluding that it provided the best opportunity to maximize value for PetSmart stockholders. *Id.* at *17, 28.

The parties signed the merger agreement the following day. *Id.* at *17. In the company's merger proxy, PetSmart disclosed the management projections but noted that the company had not historically prepared long-term projections and "caution[ed] stockholders not to place undue reliance on the[m]." *Id.* at *18. PetSmart also disclosed the sensitivity analyses that J.P. Morgan performed, explaining that the analyses were prepared to assist the board in evaluating the downside risk should the company fail to perform in line with the management projections. *Id.* PetSmart's stockholders overwhelmingly approved the transaction, and it closed on March 11, 2015. *Id.* at *18, 28. No indication of interest or topping bid emerged prior to closing. *Id.* at *18. PetSmart's performance improved during the fourth quarter of 2014, but then declined in the beginning of 2015 and through closing. *Id.* at *19-20.

Multiple hedge funds acquired PetSmart stock after the announcement of the deal and sought appraisal by the Delaware Court of Chancery of the fair value of that stock. *Id.* at *2-3. The petitioners asserted that the fair value of the company was $128.78 per share based on their expert's discounted cash flow (DCF) analysis, while the respondent requested that the court defer to the $83 per-share merger consideration. *Id.* at *2. Following trial, the court issued a memorandum opinion in which it accepted the respondent's position and found the fair value of PetSmart to be $83 per share as of the closing of the merger. *Id.* at *41.

The Court's Analysis

The court began its analysis by evaluating the sale process to determine if the deal price accurately reflected the fair value of the company. *Id.* at *27-31. The court first reaffirmed the principle that a sale process need not achieve perfection for a merger price to serve as a reliable indicator of fair value, *Id.* at *27, then identified numerous facts in the record indicating that the auction yielded fair value, including:

- The auction process was widely publicized, putting the "whole universe of potential bidders" on notice;
- The sale process was not rushed, and the board was prepared to abandon a sale and continue to operate the company on a stand-alone basis if the process failed to generate a sufficient price;
- The company contacted 27 potential bidders, including both strategic and financial bidders, and did not shut out potential bidders or favor any particular bidder;
- The merger consideration was higher than the company's stock price had ever traded and reflected a 39 percent premium over the company's unaffected stock price; and
- No indication of interest or topping bid emerged, notwithstanding the company's improved performance in the fourth quarter of 2014.

Id. at *27-28. Accordingly, the court concluded that the sale process, "while not perfect, came close enough to perfection to produce a reliable indicator of PetSmart's fair value." *Id.* at *27.

The court then proceeded to reject the petitioners' "nitpick[ing]" of the "well-constructed and fairly implemented" auction process and their criticisms of purported market dynamics that impeded higher bids. *Id.* at *29-31.

First, the court found the evidence contradicted the petitioners' contention that increased regulatory scrutiny of the amount of leverage in private equity buyouts prevented bidders from obtaining the financing necessary to fully fund their bids. *Id.* at *29.

Second, the court rejected the petitioners' argument that only financial sponsors submitted bids and those bids were generated using leveraged buyout (LBO) models designed to provide the funds "a certain internal rate of return that will always leave some portion of the company's going concern value unrealized." *Id.* The court explained that "the evidence [was] clear that [J.P. Morgan] made every effort to entice potential strategic bidders and none were interested" and that "the Board would have been receptive to a deal with Petco if only it would have expressed a serious indication of interest." *Id.* Further, the record demonstrated that "the private equity bidders did not know who they were bidding against and whether or not they were competing with strategic bidders," and, consequently, "[t]hey had every incentive to put their best offer on the table." *Id.*

Third, the court found the petitioners' suggestion that the company initiated the sale process at an inopportune time in response to pressure from an activist stockholder to be unsupported by the evidence, as the record reflected that the board had begun evaluating a sale before the stockholder threatened a proxy fight, took its time with the sale process despite the stockholder's demands, was ready and willing to

continue to operate the company on a stand-alone basis, and was prepared to defend against a proxy contest if necessary. *Id.* at *30 & n.353.

Fourth, the court rejected the petitioners' argument that the board was ill-informed, finding that a director's memory lapse at trial regarding financial details nearly three years later did not suggest that the board was uninformed, particularly given that director's extensive testimony regarding other aspects of the sale process, and that the petitioners' assertion that the board failed to obtain advice regarding the company's value on a stand-alone basis was contradicted by the record. *Id.* at *30.

Fifth, the court rejected the petitioners' contention that J.P. Morgan had conflicts of interest that impugned the results of the sale process, determining that the board was aware that J.P. Morgan, as a large institutional bank, had ties to some of the large private equity firms that submitted bids, and that it was inconsequential that J.P. Morgan had been retained by Petco in connection with its initial public offering in the fall of 2015 because J.P. Morgan had not pitched that engagement until after the sale process had ended. *Id.* The court also found no conflict arising from J.P. Morgan's previous engagement taking public an airline owned by a PetSmart director. *Id.*

Finally, the court declined to find that the merger consideration was stale as an indicator of fair value by the time of closing, concluding that PetSmart's fortunes did not take "a miraculous turn for the better" as asserted by the petitioners, but rather that the company's positive performance in the fourth quarter of 2014 was temporary, as evidenced by the company's underwhelming performance in the first quarter of 2015. *Id.* at *31.

The court next evaluated the reliability of a DCF analysis as an indicator of PetSmart's fair value. *Id.* at *31-32. To do so, the court first analyzed the reliability of the management projections, explaining that projections provide the key inputs for a DCF analysis and that "if the data inputs used in the model are not reliable, then the results of the [DCF] analysis likewise will lack reliability." *Id.* at *32 (internal citations and quotation marks omitted).

After recounting the circumstances in which the court has determined projections to be insufficiently reliable to support a DCF analysis, the court found that the management projections "are saddled with nearly all of the[ ] telltale indicators of unreliability." *Id*. at *32-33. First, PetSmart had not historically prepared long-term projections; it had only prepared one-year forecasts for budgeting purposes. *Id.* at *33. Confounding this issue, the management team that prepared the management projections was inexperienced and faced significant time pressure. *Id.* Second, the short-term forecasts that PetSmart's management had prepared in the past were frequently inaccurate, often by large margins. *Id.* Third, the management projections were not prepared in the ordinary course of business, but rather during a sale process in which management was told to "put their best foot forward" to bidders. *Id.* at *34. Finally, the management projections were designed to be overly aggressive to offset the discount that potential bidders would apply. *Id.*

The court rejected the petitioners' various attempts to defend the reliability of the management projections. The court found that the existence of an even more aggressive set of projections and other internal documents reflecting higher potential cost savings did not suggest that the management projections were reliable, explaining that the management projections remained the product of aggressive prodding by the board and the savings reflected therein represented management's best estimate under the circumstances. *Id.* at *34-35. The court also found that the company's post-signing performance did not suggest the management projections were reliable, noting that the company's "mixed" financial results did not align with the performance forecasted in the management projections. *Id.* at *34. Accordingly, the court determined that the management projections were not reliable forecasts of PetSmart's expected future cash flows, and any DCF analysis based on the management projections would be "meaningless." *Id.* at *35 (internal citations and quotation marks omitted).

The court next evaluated the reliability of projections prepared by BC Partners and the executive it had arranged to become CEO of PetSmart post-acquisition, rejecting them as reflecting how PetSmart would be run as a private company under BC Partners and with new management, and thus not reflective of PetSmart's "operative reality" as a going concern as of the closing of the merger. *Id.* at *35-36.

The court did, however, consider a DCF valuation based on the sensitivity analyses of the management projections that

J.P. Morgan had conducted, explaining that the analyses had been prepared at the board's request to provide it a more realistic understanding of the company's expected future cash flows, and were thus more reliable than the other projections in the record. *Id.* at *37. Using the sensitivity analysis that it viewed as most reliable, the court proceeded to review the DCF models offered by each party's expert, and found the analysis submitted by the respondent's expert, which yielded a valuation range of $82.79 to $86.96, to be the most reliable DCF analysis that could be performed. *Id.* at *37-40.

The court then weighed the reliability of that DCF value against the reliability of the merger consideration and determined to give exclusive weight to the latter, though noted that the DCF analysis was "confirmatory." *Id.* at *40. The court reasoned that the DCF valuation still depended on the unreliable management projections and that the petitioners' position would reflect a "massive market failure ... [i]n the wake of a robust pre-signing auction." *Id.* at *40-41. As such, the court found the company's fair value to be equal to the $83 per-share merger consideration. *Id.*

Conclusion

The court's decision in *PetSmart* to defer to the deal price represents a significant defeat for appraisal arbitrageurs and perhaps is a watershed moment in Delaware appraisal jurisprudence, signifying increased judicial deference to the "elegance" of the deal price, *Id.* at *40 n.439, whereby the court will not second-guess the price to which a willing buyer and willing seller have agreed in an arm's-length transaction in the market absent unusual circumstances.

In important respects, *PetSmart* expands the contexts in which the court will defer to the merger price rather than use the DCF valuation method, thereby further limiting the situations in which fair value may be determined by the often-volatile, assumption-based DCF valuation method on which arbitrageurs have relied for their returns. Most notably, the court assuaged transaction planners' concerns, arising from the decision last year in *In re Appraisal of Dell Inc.,* 2016 WL 3186538, at *29 (Del. Ch. May 31, 2016), that private equity buyouts might be viewed as inherently resulting in a deal price below fair value because of the use of LBO pricing models, which derive a price a financial sponsor can pay while still achieving a particular internal rate of return. In *PetSmart,* the court soundly rejected that proposition, explaining that it would be improper for it to rely on economic theory absent record evidence supporting the application of the theory in the particular case, and finding no such evidence in the trial record. 2017 WL 2303599, at *1 & 29 n.352. The court further noted the fallacy of the proposition, observing that both strategic and financial acquirers generally pay more than a target company's value and that financial bidders may even be willing to pay more than strategic bidders in certain contexts because they may be more inclined to take on risk. *Id.* at *29 n.352.

Also noteworthy is the court's rejection of the petitioners' argument that the deal price was not reflective of PetSmart's fair value because the transaction occurred during a valuation low point or period of uncertainty. *Id.* at *29-30 & n.353. The court found inapposite *In re Appraisal of DFC Global Corp.*, 2016 WL 3753123, at *22 (Del. Ch. July 8, 2016), *modified on rearg.,* Consol. C.A. No. 10107-CB (Del. Ch. Sept. 14, 2016) (declining to rely exclusively on deal price because transaction occurred while company was in performance trough and experiencing significant internal turmoil and regulatory uncertainty), finding that the record demonstrated that PetSmart's struggles and the industry headwinds it faced were well-known to the market and not of recent origin, and that its improved fourth-quarter 2014 performance (which was followed by poor results in the first quarter of 2015) did not suggest that the company's problems were transitory. *PetSmart,* 2017 WL 2303599, at *29-31 & n.353. In so doing, the court distinguished the "acute regulatory uncertainty" involved in DFC from the everyday problems and underperformance plaguing many companies for sale, thereby indicating that only in rare circumstances will the court decline to rely on the deal price because the transaction was inopportunely timed. *Id.* at *30 n.353.

In addition, the court made clear that it will not undertake a DCF valuation, let alone rely on that methodology rather than defer to the deal price, absent record evidence showing that the management projections to be used are reliable estimates of the company's expected future cash flows. Thus, the court will not use projections simply because they were management's best estimates or were disclosed in the merger proxy or tender offer statement. Nor will the court rely on projections that never were approved by the board or used by management to run the business. The court also will not use projections that represent an aspirational sales case or an estimate of the company's performance as part

of the buyer (and not as a going concern). And, critically, the court will not use projections that were created or altered by a party's paid expert to achieve a litigation outcome that diverges from market reality.

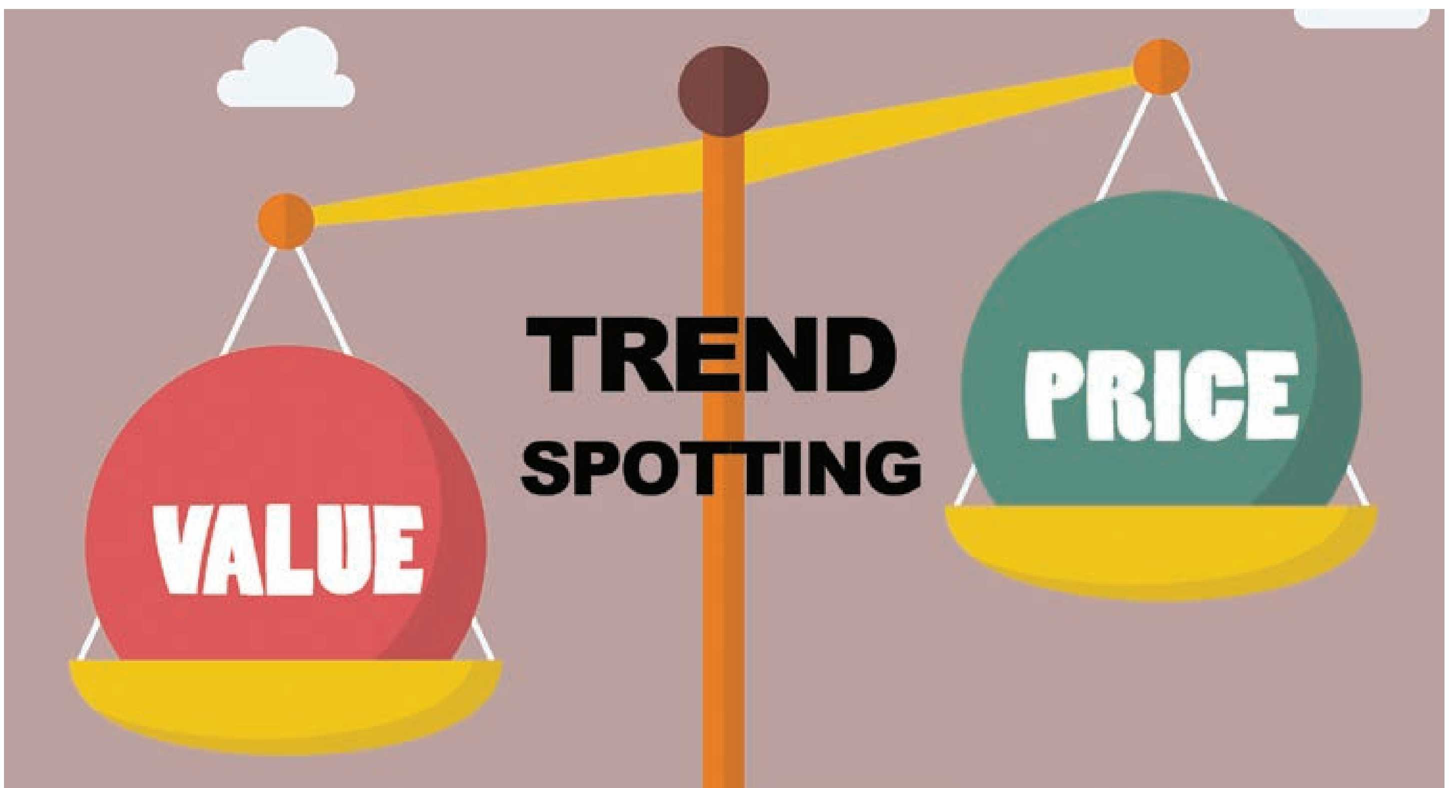
Lastly, the *PetSmart* decision is an important precedent for Chancery litigators because it allows a corporate defendant to use its executives' deposition testimony as evidence at trial over a plaintiff's objection. Parties in Chancery proceedings often stipulate to the admissibility of deposition testimony of fact witnesses, subject to any evidentiary objection as if the testimony were live at trial. In recent years, though, certain plaintiffs firms have refused to observe this common practice, and a decision by the Court in *ACP Master Ltd. v. Sprint Corp.*, 2017 WL 75851, at *3 (Del. Ch. Jan. 9, 2017), holding that a corporate defendant's use of its executives' deposition testimony was inadmissible hearsay, served to further embolden them. However, in *PetSmart,* the court allowed the company to use the deposition testimony of its executives who did not testify at trial pursuant to Court of Chancery Rule 32(a)(3)(B), reasoning that the deposition testimony was admissible even if the company could have brought the witnesses to testify at trial because the witnesses were "out of the state of Delaware" and, without evidence it had "actively taken steps to keep the deponent from setting foot in the court-room," the company had not "procured" their absence. 2017 WL 2303599, at *5 n.37 (internal quotations, citations, and alterations omitted). For the same reasons, the court also held that the witnesses were "unavailable," and thus the deposition testimony was not inadmissible hearsay under Delaware Rule of Evidence 804(a)(5) and (b)(1). *Id.* In addition, the court permitted the company to proffer deposition testimony of witnesses who testified at trial on its behalf under the "rule of completeness" codified in Court of Chancery Rule 32(a)(4) and Delaware Rule of Evidence 106. *Id.* at *16 n.211.

This article was originally published in the June 29, 2017 issue of Law360.

Recent Cases Continue Delaware Trend Toward Reliance on Deal Price in Appraisal Litigation

Business Law Today, June 2017

Timothy R. Dudderar and J. Matthew Belger



Appraisal litigation is increasingly one of the primary post-closing threats facing acquirers of Delaware corporations. As a result, corporate practitioners have become keenly focused on appraisal decisions from the Delaware courts, particularly those involving the courts' consideration of the deal price as potential evidence of fair value. A move toward or away from a permanent role for deal price in the court's fair value determination would have a significant impact for both petitioners seeking appraisal and the corporations attempting to fend off appraisal claims. Two recent decisions of the Court of Chancery—*In re Appraisal of PetSmart, Inc.* and *In re Appraisal of SWS Group, Inc.*—address this very issue and will add to the growing number of cases providing guidance regarding when deal price will be used as a reliable indicator of fair value.

Appraisal Rights and the Role of Deal Price

Section 262 of the Delaware General Corporation Law (the "Appraisal Statute") provides dissenting stockholders in certain mergers and consolidations with the right to be

awarded the "fair value" of their stock as determined by the Court of Chancery. The Appraisal Statute directs the court in an appraisal proceeding to determine fair value of the petitioner's stock by taking into account "all relevant factors" while excluding from its fair value determination "any element of value arising from the accomplishment or expectation of the merger or consolidation." Delaware courts have interpreted this statutory language to mean that the court has wide discretion to consider proof of fair value by any method of valuation, provided only that it is admissible.

Despite the broad discretion granted by the Appraisal Statute to consider any relevant source of evidence of fair value, Delaware courts have largely relied on a handful of valuation methods. Of these, by far the most commonly employed in appraisal proceedings has been the discounted cash flow valuation (DCF) method. As a result, appraisal proceedings often devolve into a battle of experts offering widely divergent opinions with respect to the value of the petitioner's stock. The Court of Chancery is not obligated to adopt in whole or in part the opinion of any party's expert and frequently will construct its own analysis based upon those aspects of the experts' opinions the court finds most reliable. Given the technical nature of this exercise and the precision of arriving at an exact value as required by the Appraisal Statute, the "law trained" members of the Court of Chancery have at times expressed unease with the task of determining fair value in this manner.

While, as indicated above, the majority of appraisal cases have been decided based upon the application of traditional valuation methodologies, a significant number of cases have also seen the court consider the deal price in its fair value analysis and, in several of those cases, adopt the deal price as the best and most reliable evidence of fair value. In such cases, the court has generally found that the process leading to the merger was free of conflict and conducted in a manner intended to achieve the highest price reasonably available. Though the case law makes clear that the court may not simply defer to the deal price even if the process is found to be flawless, one can discern from certain decisions a preference for adopting deal price (provided the court concludes that the process was sufficient) over the application of even well-accepted valuation methodologies such as a DCF analysis. Further, in several cases, the court has justified its adoption of deal price as the best evidence of fair value in part because it was unable to rely upon traditional valuation methodologies, including a DCF analysis, due to specific issues with certain inputs. Even where the court has found a DCF analysis reliable, the court has, in some cases, still based its fair value determination exclusively upon the deal price, using the value derived from the DCF analysis as a check supporting the reliability of the price achieved in the underlying merger.

In practice, the prospect of the court adopting deal price as fair value can be very attractive to corporations facing an appraisal demand. More than imposing a potential "cap" on any fair value award (which it does, if applied), a finding that deal price represents fair value may result in a fair value award of less than the deal price. As noted above, the Appraisal Statute prohibits the court from including in its fair value determination "any element of value arising from the accomplishment or expectation of the merger or consolidation." To the extent the respondent corporation can demonstrate that the deal price reflects some measure of synergistic value, the court may subtract such value from its final fair value determination consistent with the Appraisal Statute.

Though arguing for the adoption of deal price as fair value also carries with it some risks—including opening up discovery into the merger process and related potential for exposure to process and disclosure-based damage claims—it remains a potent weapon for companies facing appraisal claims. Accordingly, corporate practitioners have closely watched appraisal-related developments in the Delaware courts, particularly those cases where the court is confronted with an argument that it ought to adopt deal price as fair value.

PetSmart

This case involved a petition for appraisal filed by stockholders of PetSmart, Inc. following its acquisition by BC Partners, Inc., an unrelated third-party, for $83 per share in cash. PetSmart argued that the price BC Partners paid in an arm's-length transaction following a thorough pre-signing auction was the best evidence of fair value. Petitioners disagreed, arguing that the deal price was unreliable for a number of reasons and that PetSmart's fair value at the time of the merger was $128.78 per share based on a DCF analysis performed by petitioners' expert.

The court framed the issue regarding the reliability of the deal price as an indicator of fair value as whether "the

transactional process leading to the Merger [was] fair, well-functioning and free of structural impediments to achieving fair value for the Company." The court thoroughly reviewed the evidence presented at trial regarding the sale process, which began in the summer of 2014 when the PetSmart board determined to pursue a sale, engaged JP Morgan as a financial advisor, and formed an "Ad Hoc Committee of experienced independent directors to oversee the process." In August 2014, PetSmart publicly announced that it was exploring strategic alternatives, including a sale. JP Morgan contacted 27 potential bidders, including three potential strategic buyers JP Morgan considered most likely to be interested in acquiring PetSmart. While none of the potential strategic buyers elected to participate in the process, fifteen financial sponsors signed non-disclosure agreements and engaged in due diligence. PetSmart received five indications of interest, and three bidders continued with the process. The court found no evidence that JP Morgan or PetSmart's board or management colluded with or favored any bidder. The resulting high bid of $83 per share was "higher than PetSmart stock had ever traded and reflected a premium of 39% over its unaffected stock price." The board accepted that offer in December 2014. PetSmart stockholders overwhelmingly approved it in March 2015, and did so having in hand the same management projections that petitioners' expert used as the basis for his DCF analysis.

Based on this process, the court found that the deal price was the best evidence of fair value because PetSmart "carried its burden of demonstrating that the process leading to the Merger was reasonably designed and properly implemented to attain the fair value of the Company." The court rejected each of the petitioners' arguments that the sale process was defective and that the deal price was therefore unreliable. Perhaps most notably, the court rejected petitioners' argument that "the lack of strategic bidders left PetSmart at the mercy of financial sponsors and their 'LBO Models,'" which petitioners argued would "rarely if ever produce fair value because the model is built to allow the funds to realize a certain internal rate of return that will always leave some portion of the company's going concern value unrealized." The court noted, among other things, that JP Morgan "made every effort to entice potential strategic bidders and none were interested," and concluded that "while it is true that private equity firms construct their bids with desired returns in mind, it does not follow that a private equity firm's final offer at the end of a robust and competitive auction cannot ultimately be the best indicator of fair value for the company."

The court declined to adjust its view of fair value based on a DCF analysis. The court observed, as a general matter, that petitioners' DCF valuation suggested that PetSmart left nearly $4.5 billion on the table, and that there was no evidence of "confounding factors" that would have caused such a "massive market failure." The court ultimately declined to rely on a DCF valuation because it found that the projections prepared by PetSmart's management were unreliable. The court cited in that regard the fact that long-term projections were not created in the ordinary course of PetSmart's business, management was under "intense pressure from the Board to be aggressive" in creating the projections, and PetSmart frequently missed even its short term projections. The court therefore decided to "defer" to the deal price as the best indicator of PetSmart's fair value.

SWS

The petitioners in this case sought appraisal of their stock of SWS Group, Inc. following the merger of SWS Group into a subsidiary of Hilltop Holdings, Inc., a substantial creditor of SWS. Although no party argued that the deal price was the best indicator of fair value, the court nevertheless analyzed it, ultimately finding it unreliable. Chief among the "unique facts" that led the court to that conclusion were credit and other agreements that gave Hilltop certain rights, including the right to appoint a director and a board "observer," as well as the ability to enforce a "Fundamental Change" covenant that could block a sale of SWS. Hilltop refused to waive that covenant, and the court noted the "probable effect on deal price" of that veto power over competing offers. The court likewise observed that the SWS board did not appear to fully pursue potential competing bidders and that Hilltop's observer on the SWS board had access to inside information not available to others in the market. As a result, the court found that "structural limitations unique to SWS make the application of the merger price not the most reliable indicia of fair value."

Having so concluded, the court performed a DCF analysis based on largely contested inputs from the parties' experts. The court resolved disputes regarding, among other things, the appropriate adjustments to management's financial projections, whether "excess capital" should be added to the result of the DCF analysis, and the appropriate inputs

for the discount rate. The resulting DCF analysis produced a value of $6.38 per share, which was below the $6.92 per share value of the merger consideration at closing. The court noted that a fair value below the deal price was not surprising because the deal was a "synergies-driven transaction" that was expected to result in synergies such as overhead cost savings that should not be included in the fair value for purposes of appraisal.

Key Takeaways

Although appraisal decisions are necessarily based on the unique fact and expert evidence presented by the parties, *PetSmart* and *SWS* provide valuable guidance regarding the role of the deal price and synergies in the Court of Chancery's approach to appraisal cases.

First, these cases can be seen as further evidence of a trend toward an increased focus on the deal price as a potential measure of fair value. *PetSmart* is only the latest in a line of decisions in recent years that relied on the deal price as the best evidence of fair value. And, although no party in *SWS* sought to invoke the deal price, the Court nevertheless evaluated its reliability and declined to use it only because of certain impediments "unique to SWS." The Delaware Supreme Court's decisions in the pending *DFC Global* and *Dell* appeals are likely to provide additional, if not conclusive, guidance on the appropriate role of the deal price as an indicator of fair value.

Second, existing case law established that the reliability of the deal price depends largely on the quality of the process leading to the transaction. As the cases described above confirm, a thorough process undertaken in a well-functioning market can result in a highly reliable deal price (as in *PetSmart*) that the court may rely upon as conclusive evidence of fair value, while a process plagued by structural limitations and market failures may be deemed unreliable (as in *SWS*).

Third, *PetSmart* is notable for its holding that a process dominated by financial buyers does not preclude a finding that the deal price is the best indicator of fair value. Some may see that holding as a counterpoint to the Court of Chancery's much-discussed 2016 decision in *In re Appraisal of Dell Inc.,* which held that an acquisition by a financial buyer using an "LBO pricing model" designed to generate outsized returns was a factor undermining the reliability of the deal price.

Fourth, it is clear that the Court of Chancery is aware of what the *PetSmart* decision described as the "unique challenges to the judicial factfinder" presented in appraisal cases, in which the court must evaluate evidence and expert testimony presented in an adversarial trial and then independently determine fair value, without simply choosing one party's position over the other. Practitioners should keep in mind that the court may be skeptical of experts whose valuations are vastly far apart and is unlikely to simply split the difference between the parties' positions. Indeed, the court in *PetSmart* noted that reliance on the deal price "does project a certain elegance that is very appealing" in light of the "wildly divergent opinions" offered by the parties' experts. It is not difficult to see why judges may be inclined to rely heavily or exclusively upon a deal price tested by "objective market reality" as an indicator of fair value rather than a judicially-determined DCF analysis based on contested inputs.

Fifth, the court recognizes that synergies expected to be achieved as a result of the transaction should not be included in fair value. While neither case performed such an analysis, *PetSmart* and *SWS* together suggest that, in an appropriate case, fair value may be the deal price less the expected synergies that contributed to the value the acquirer agreed to pay. Such a finding would, of course, result in a fair value determination below the deal price.

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Delaware Chancery Court Once Again Defers to Merger Price in Appraisal Proceeding (Parts 1 and 2)

Corporate Counsel Weekly, March 20 and 22, 2017

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PART 1

Under Delaware law, stockholders of a corporation acquired in certain mergers or consolidations who satisfy applicable statutory requirements are entitled to an appraisal by the chancery court of the "fair value" of their stock in the acquired company. Because an appraisal petitioner need not own the appraised stock at the time a merger agreement is signed, and because of the above-market interest generally available under the appraisal statute, opportunistic hedge funds in recent years have increasingly used appraisal as an investment strategy, buying large numbers of shares in target corporations after the announcement of mergers for the sole purpose of pursuing appraisal. As a result, there has been a marked upsurge in appraisal litigation of late.

Contemporaneously with this rise in "appraisal arbitrage," and perhaps as a form of judicial response to it, the chancery court has become more willing to rely on the merger price as the primary or sole indicator of the fair value of appraised stock. While historically the court has tended to favor the discounted cash flow (DCF) method of valuation, on several occasions in the past few years the court has eschewed the DCF method (as well as other valuation methodologies) and instead given exclusive weight to the merger price in making its fair value determination where the underlying transaction resulted from an arm's-length sale process and a well-functioning market. In each of these cases the court found that the sale process leading to the transaction could be depended upon to have generated a merger price indicative of the fair value of the acquired company. The court also found in each case that alternative methods of valuation were unreliable or weak, including that the financial projections prepared by the acquired company's management team were unreliable for purposes of a DCF valuation.

For example, in *Huff Fund Investment Partnership v. CKx, Inc.,* the court relied on the merger price resulting from a "full market canvas and auction" that was "free of fiduciary and process irregularities" to determine fair value. 2013 WL 5878807, at *1, 2013 BL 305297 (Del. Ch. Nov. 1, 2013). On the other hand, the court found that the acquired company had no sufficiently comparable peers and that management's projections were unreliable, rendering the merger price "the best and most reliable indication of [the company's] value." *Id.* at *1, *10-11. Similarly, in *In re Appraisal of Ancestry.com, Inc.,* the court relied on the merger price, which resulted from an auction process involving a "market canvas," to determine fair value where there were "no comparable companies to use for purposes of valuation" and the DCF analyses offered by the parties' experts were based on management projections created outside the normal course of business and under circumstances that casted doubt on their accuracy. 2015 WL 399726, at *1, *17-18, *23-24, 2015 BL 23048 (Del. Ch. Jan. 30, 2015). And, in *Merlin Partners LP v. AutoInfo, Inc.,* the court relied on the merger price resulting from a "strong" arm's-length sale process where there were no comparable companies or transactions and the experts' DCF valuations relied on projections prepared by a management team that "itself had no confidence in its ability to forecast" the company's performance and were designed to be overly optimistic to facilitate a sale. 2015 WL 2069417, at *7-11, *14, *17-18, 2015 BL 127097 (Del. Ch. Apr. 30, 2015). Likewise, in *Long-Path Capital, LLC v. Ramtron International Corp.,* the court again found that there were no comparable companies or transactions for valuation purposes and declined to rely on DCF valuations based on unrealistic management projections prepared in anticipation of litigation using unusual methodologies, and instead concluded that the merger price resulting from a "thorough" sale process, less synergies, provided the best indication of fair value. 2015 WL 4540443, at *1, *10-13, *18-20, 2015 BL 208944 (Del. Ch. June 30, 2015). Finally, in *Merion Capital LP v. BMC Software, Inc.,* the court relied on the merger price generated by "a thorough and vigorous sales process" where neither expert proffered a value based on comparables and management's projections "were historically problematic, in a way that could distort value" in a DCF analysis. 2015 WL 6164771, at *1, *14, *18, 2015 BL 346010 (Del. Ch. Oct. 21, 2015).

In contrast, the court has declined to rely exclusively on the merger price where it has found, based on the particular facts of the case, that the sale did not generate reliable evidence of fair value. In *In re Appraisal of Dell Inc.,* for example, the court gave limited weight to the deal price in a management/private-equity buyout and instead used a DCF analysis to conclude that the fair value of the company was 28 percent higher. 2016 WL 3186538, at *51, 2016 BL 171251 (Del. Ch. May 31, 2016). While finding that the sale process and deal price were sufficient to exclude the possibility of a greater disparity in value, a number of factors caused the court not to give more weight to the deal price, including that: the transaction was a management buyout; the bidders used a leveraged buyout pricing model to determine the merger consideration; a "valuation gap [existed] between the market's perception and the Company's operative reality"; there was limited pre-signing competition; and the post-signing go-shop "was not sufficiently persuasive to rule out smaller valuation gaps" given the size and complexity of the company, potential bidders' perception that incumbent management had an informational advantage, and the value of the founder to the company. *Id.* at *29-44, *51. More recently, in *In re Appraisal of DFC Global Corp.,* the court found that the transaction "was negotiated and consummated during a period of significant company turmoil and regulatory uncertainty," and, as a result, concluded that the most reliable way to determine the fair value of the company's stock was to give equal weight to "three imperfect techniques"—a DCF model incorporating certain methodologies and assumptions each expert made (as well as some made by the court), the comparable company analysis the respondent's expert performed, and the deal price—generating a fair value approximately 8 percent higher than the deal price. 2016 WL 3753123, at *1, *23, 2016 BL 219857 (Del. Ch. July 8, 2016), *modified on rearg.,* Consol. C.A. No. 10107-CB (Del. Ch. Sept. 14, 2016). And, in *Dunmire v. Farmers & Merchants Bancorp of Western Pennsylvania, Inc.,* the court declined to afford any weight to the merger price where a controlling stockholder stood on both sides of the transaction, which was not conditioned on obtaining the approval of a majority of the minority stockholders, and, although a special committee negotiated the transaction for the target company, two of its three members had business ties to the controller and "the record d[id] not inspire confidence that the negotiations were truly arm[']s-length." 2016 WL 6651411, at *7-8, 2016 BL 375566 (Del. Ch. Nov. 10, 2016). As a result, the court declined to defer to the deal price and instead relied on a discounted net income model utilized by both experts,

concluding that the fair value of the acquired company's stock was approximately 11 percent higher than the deal price. *Id.* at *1, *16.

Against this backdrop, there remained the question whether the chancery court would defer to the merger price where both the sale process and alternative valuation methods were sufficiently reliable for purposes of a fair value determination. 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). We discuss this important chancery court decision and its impact in the second article of this two-part series.

PART 2

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 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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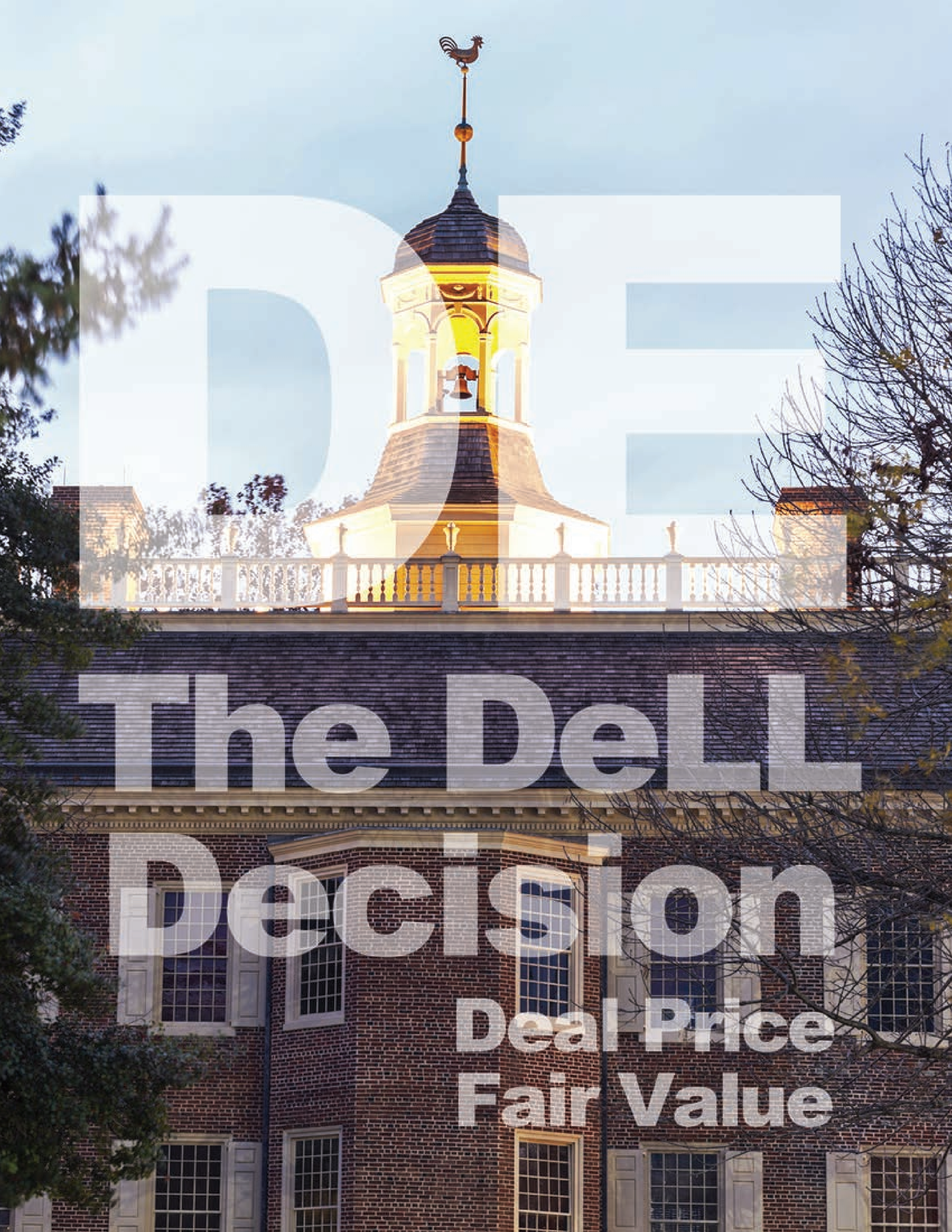
DE
The DeLL Decision
Deal Price
Fair Value

In re Appraisal of Dell Inc.: The Continuing Relevance of Deal Price in Delaware Appraisal Proceedings

Business Law Today, July 2016

Timothy R. Dudderar and Rebecca E. Salko

In a recent opinion, *In re Appraisal of Dell Inc.*, the Delaware Court of Chancery awarded the appraisal petitioners fair value for their shares well in excess of the price paid to the other public stockholders of Dell Inc. when it was acquired via a management-led buyout in 2012. Immediately following this decision, some practitioners noted that it broke with several recent appraisal opinions in which the Court of Chancery adopted the merger consideration as the best evidence of fair value and expressed concerns that *Dell* might signal a shift in Delaware appraisal law away from deferring to a negotiated merger price in appraisal cases. A closer review of the decision, however, indicates there is no cause for alarm. While the *Dell* court did not ultimately defer to the merger consideration, the opinion's thorough analysis of the underlying deal process should be read as affirming that Delaware courts will continue to routinely and carefully consider merger price in appraisal proceedings and "often," but not always, find that such price is representative of fair value. At most, *Dell* establishes that MBOs present special issues in the appraisal context and warrant careful consideration by the court when deciding whether the deal price should influence its determination of fair value.

Statutory and Decisional Law Regarding Delaware Appraisal Proceedings

Section 262 of the DGCL provides stockholders who did not vote in favor of a cash out merger a right to have the "fair value" of their shares determined by the Court of Chancery by way of an appraisal proceeding. In determining fair value, the court must consider "all relevant factors" and exclude "any element of value arising from the accomplishment or expectation of the merger. . . ." Fair value in the appraisal context has been interpreted by the Delaware Supreme Court as "the value of the company to the stockholder as a going concern." In practice, the appraisal statute gives the Court of Chancery broad discretion in determining the fair value of the shares at issue and the court may choose to accept a valuation submitted by either party or make its own independent determination of fair value.

For the past two decades, Delaware courts have considered, to varying degrees, the deal price as a relevant factor and in a number of cases have found it to be the best indicator of a company's going concern value. *In Union Illinois 1995 Investment Limited Partnership v. Union Financial,* decided in 2003, then-Vice Chancellor Strine gave 100 percent weight to the price resulting from an auction of Union Financial Group (UFG). In finding that the merger consideration was the best indication of fair value, then-Vice Chancellor Strine noted that UFG "was marketed in an effective manner, with an active auction following the provision of full information to an array of logical bidders." Relying on the merger consideration as the sole evidence of fair value was appropriate, according to the court, because the merger resulted from an effective process with third-party bidders, as opposed to a squeeze-out merger, and the process had no material flaws. The court gave no weight to the expert-generated discounted cash flow (DCF) analyses, finding that method inferior to the value resulting from the sale process undertaken by UFG.

Accordingly, the court found fair value to be the merger price less the value of merger-related synergies.

Between 2003 and 2010, the issue of merger consideration influencing the Court of Chancery's determination of fair value was addressed in a handful of appraisal cases. In *Highfields Capital Ltd. v. AXA Financial Inc.,* for example, the court gave significant weight to the merger price because it found that the merger, consistent with *Union Illinois,* "resulted from an arm's length bargaining process where no structural impediments existed that might prevent a topping bid." On the other hand, in *Global GT LP v. Golden Telecom, Inc.,* the court rejected the argument that the merger price was a reliable indicator of fair value because the special committee formed by the target's board had not engaged in any efforts to sell the company, but had instead "concentrated solely on getting as good a deal as it could" from the acquirer. The court therefore accorded no weight to the merger process and instead relied upon a DCF analysis to determine fair value. On appeal, the Delaware Supreme Court affirmed. In its affirming opinion, the Supreme Court declined to adopt a presumption that merger price is indicative of fair value in appraisal proceedings, reasoning that "requiring the Court of Chancery to defer . . . to the merger consideration would contravene the unambiguous language of the statute"—which requires the court to consider "all relevant factors"—and would "inappropriately shift the responsibility to determine 'fair value' from the court to private parties." Some post–*Golden Telecom* opinions, such as *Merion Capital v. 3M Cogent,* appeared to read *Golden Telecom* as diminishing the relevance of the negotiated merger price to the determination of fair value in the appraisal context.

More recently, however, the Court of Chancery issued a string of opinions in which it substantially, if not entirely, relied upon the merger price in determining fair value. The first of these opinions, *Huff Fund Investment P'Ship v. CKx, Inc.,* described the court's task, post–*Golden Telecom,* as deciding which recognized method of valuation provides the most reliable evidence of fair value. Those methods, according to the *Huff* court, are the DCF method, a comparable companies analysis, a comparable transactions analysis and the merger price itself "so long as the process leading to the transaction is a reliable indicator of value and merger-specific value is excluded." The *Huff* court ultimately determined that, in that case, the DCF and comparable companies and transactions analyses could not be relied upon as accurate indicators of fair value of the acquired company and that the merger price was the best, and indeed only, accurate evidence of fair value. Subsequently, in *Merlin Partners LP v. Autoinfo, Inc., Longpath Capital, LLC v. Ramtron Int'l Corp* and *Merion Capital LP v. BMC Software, Inc.,* the court relied primarily on the merger consideration to determine fair value after finding that other methods employed by the parties' experts to value the targets, most prominently the DCF method, were flawed or contained uncertainties. Importantly, in each of these cases, the Court also found no reason for concern in relying upon the merger price given the evidence regarding the effectiveness of the processes leading to the transactions at issue. In yet another case—*In re Appraisal of Ancestry.com*—the court gave great weight to the merger consideration, even though it found the DCF method reliable, based upon its view that the sale process was "reasonable, wide-ranging and produced a motivated buyer." The *Ancestry* court also relied upon its earlier dismissal of a complaint challenging the transaction as a breach of the target board's fiduciary duties but noted that "a conclusion that a sale was conducted by directors who complied with their fiduciary duties is not dispositive of the question of whether that sale generated fair value."

The *Dell* Decision

As noted above, in *Dell,* the court declined to rely upon the merger price of $13.75 per share as an indicator of fair value, relying instead upon a DCF analysis that indicated fair value was $17.62 per share, a 28 percent difference. The fact that the transaction was a management buyout, led by Michael Dell, the founder and longtime CEO of the company, featured prominently in the court's consideration of the deal price as evidence of fair value. Citing the "vast amount of case law and scholarship" addressing MBOs, the court opined that "a claim that the bargained-for price in an MBO represents fair value should be evaluated with greater thoroughness and care than, at the other end of the spectrum, a transaction with a strategic buyer in which management will not be retained." With that framework in mind, the court thoroughly analyzed the process, finding the following aspects of both the pre- and post-signing phases undercut the reliability of the deal price as an indicator of fair value: (1) the heavy influence of the LBO pricing model on the bidding process; (2) lack of meaningful competition among prospective bidders; and (3) evidence of a significant gap between the company's intrinsic value and the market's perception of the company's value.

The LBO pricing model is employed by financial sponsors to "determine whether and how much to bid" when proposing a leveraged buyout, like an MBO, and "solves for the range of prices that a financial sponsor can pay while still" achieving its target internal rate of return (IRR). According to the court, the range of prices resulting from an LBO model can differ significantly from fair value because of both the financial sponsor's need to achieve significant IRRs and "limits on the amount of leverage that the company can support and the sponsor can use to finance the deal." During the pre-signing phase, the committee handling the merger negotiations on behalf of Dell's board engaged with only financial sponsors, meaning that the "price negotiations during the pre-signing phase were driven by the financial sponsors' willingness to pay based on their LBO pricing models rather than the fair value of the Company." Indeed, the committee's financial advisors advised the committee that the financial sponsors involved in the process would determine their offering prices based upon their LBO models and that a going concern (DCF) analysis using the same inputs indicated a higher range of prices for the company. Accordingly, the court found that because the merger consideration resulting from the pre-signing phase of the process was "dictated by what a financial sponsor could pay and still generate outsized returns," it necessarily "undervalued the Company as a going concern."

The *Dell* court also found a lack of meaningful competition among bidders during the pre-signing phase of the transaction. As noted above, the committee engaged with only financial sponsors during the pre-signing phase of the process and did not contact any strategic bidders. Involving strategic bidders would have not only meant additional parties submitting bids, but would also have introduced into the process an alternative form of transaction to the LBOs proposed by the financial bidders. The lack of such competition, according to the court, deprived the committee of a more meaningful bidding process, the "most powerful tool" a committee has to extract value from a potential acquirer. The court found the lack of pre-signing competition especially problematic here because post-signing market checks "rarely produce topping bids" in the MBO context, due in part to the reluctance among larger private equity sponsors to interfere with each other's signed deals. Given the "critical" nature of the price established in the pre-signing phase of MBO transactions, the limited competition during this phase of the Dell process further undermined the reliability of the deal price as evidence of fair value.

Finally, the court found that the price generated by the pre-signing phase was negatively impacted by a "valuation gap between the market's perception and the Company's operative reality." Over a period of several years, the company had spent approximately $14 billion to acquire several businesses that Michael Dell believed would complete the company's transformation from primarily a producer of personal computers to a provider of software and services to enterprise customers. But because, as of the pre-signing phase, this transformation had yet to bear fruit in the form of operating results, these expected results were not reflected in Dell's market price. The court found ample evidence of such a gap, including that the committee's advisors determined the standalone value of the company was well above Dell's trading price. Relying on precedent, the court noted that appraisal proceedings can and should address opportunistic timing and found that the evidence of the valuation gap was so compelling in this case that it further served to weaken the case for accepting the merger consideration as evidence of fair value.

The court also found flaws in the post-signing phase of the transaction that undercut the reliability of the merger consideration as fair value. The deal reached with the management group provided for a 45-day go-shop. Despite the go-shop having attracted two higher bids and caused a $0.10 per share increase in the merger consideration, the *Dell* court found structural issues with the go-shop such that it could not remedy the pre-signing deficiencies. According to the court, the emergence of two additional bids, which it acknowledged are rare in the context of MBO go-shops, indicated the original merger consideration undervalued the company, even using LBO metrics. The court also found that although the go-shop may have been adequate in the abstract, the size and complexity of the company itself made the diligence necessary to submit a topping bid foreboding. The court found that the magnitude of such a task likely had a chilling effect on potential bidders. The court expressed further concerns about the value-reducing impact of a "winner's curse;" that is, the perception that a bid above the price management had agreed to pay meant that the bidder was paying more than management, with its superior knowledge, thinks the company is worth. In addition, the court noted that any potential buyer faced a unique problem in potentially purchasing Dell without Mr. Dell's full participation post-acquisition. The court indicated that it, and likely other potential bidders at the

time, believed that if Mr. Dell left the company after a sale, the company would lose significant value, as it had in the past when Mr. Dell temporarily left the company. Mr. Dell's unique role was considered another impediment to potential bidders during the go-shop period.

In light of these findings regarding the pre-and post-signing process, the court declined to give any weight to the merger consideration in determining the fair value of Dell. The court instead found that a DCF analysis, based on projections the court found reliable, was the best indicator of fair value.

Conclusion

Dell does not appear to signal a shift in Delaware appraisal jurisprudence. As the *Dell* court recognized, Delaware courts are required to consider the deal price as one of the relevant factors in determining fair value, and, importantly, will "often" find the merger consideration is the best evidence of fair value, particularly where the merger consideration results from a robust sale process in which the board negotiates with potential bidders at arm's length. *Dell* does, however, indicate that MBO transactions will be subject to more rigorous scrutiny in the context of appraisal proceedings and, given certain inherent realities, may be less likely to be found to have produced a price equal to fair value. Even so, *Dell* does not foreclose a finding that the deal price in an MBO transaction equals fair value.

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CASE SUMMARIES

Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.

C.A. No. 11448-VCL (Del. Ch. Feb. 15, 2018) (Laster, V.C.)

In the first appraisal decision of a public company following the Delaware Supreme Court's opinions in *DFC* and *Dell*, the Court of Chancery determined the unaffected market price of Aruba Networks, Inc. ("Aruba"), which was more than 30% lower than the price Hewlett-Packard Company ("HP") paid to acquire Aruba, provided the most persuasive evidence of fair value. It appears unlikely that this decision is the harbinger of a line of cases setting fair value at the unaffected market price. Nonetheless, the decision is a must read for practitioners because it highlights a number of issues at the forefront of appraisal litigation following the Delaware Supreme Court's forceful application of the efficient capital market hypothesis in *DFC* and *Dell*.

Following HP's acquisition of Aruba for $24.67 per share, Verition Partners Master Fund and Verition Multi-Strategy Master Fund ("Petitioners") filed an appraisal proceeding. The parties advanced three methods for determining Aruba's fair value: (1) Aruba's unaffected market price; (2) deal price; and (3) discounted cash flow.

In addressing the reliability of the unaffected market price, the Court noted that both *DFC* and *Dell* endorsed a "traditional version" of the efficient capital market hypothesis, pursuant to which market price is a reliable indicator of fair value when the market for a company's stock has certain attributes—many stockholders, no controlling stockholder, highly active trading, and widespread information. But the Court observed that there is a "growing body of literature that raises questions about the assumptions undergirding" that traditional version, and suggested that "future appraisal litigants might retain experts on market efficiency" to permit future appraisal decisions to consider "subtler aspects of the efficient capital markets hypothesis." Noting that the Petitioners had not provided any such expert testimony, however, the Court found that Aruba possessed the attributes of an efficient market identified in *DFC* and *Dell*, and concluded that Aruba's unaffected thirty-day average market price of $17.13 per share was reliable evidence of value.

The Court also determined that the deal price, despite the absence of meaningful competition among potential bidders, was probative evidence of fair value. In reaching that determination, the Court interpreted the Supreme Court's guidance on deal price to focus on whether the transaction was negotiated fairly, not whether a higher price could have been obtained. The Court then adjusted the deal price downward to account for the value of synergies associated with the merger. Although the Delaware Courts have routinely recognized that such an adjustment may be appropriate, the Court of Chancery has rarely made such an adjustment. And, as the Court recognized, there is considerable difficulty in backing out synergies with precision. That imprecision notwithstanding, the Court concluded that deal-price-less-synergies valued Aruba at $18.20 per share.

Finally, the Court considered each sides' discounted cash flow method. After identifying issues with each experts' valuation, the Court rejected the discounted cash flow method here because there was no evidence that the market could not be relied on to ensure fair treatment. As practitioners will note, while consistent with the language of *Dell*, this is a marked departure from the Delaware Courts' historical reliance on the discounted cash flow method as probative evidence of fair value, even where there is an efficient market.

After considering the three valuation methodologies, the Court held that Aruba's unaffected market price provided the most straightforward and reliable method for determining Aruba's fair value as a going concern. In reaching its decision, the Court noted that both market price and deal-price-less-synergies were probative of fair value. However, the Court

noted that the unaffected market price is the direct result of numerous market participants whereas the deal-price-less-synergies involves judgment and uncertainty.

This is an important decision as Delaware Courts begin to apply the teachings of, and address the questions raised by, *DFC* and *Dell*. The Court of Chancery followed the Supreme Court's guidance that market price and deal price are highly probative of fair value, and rejected applying the discounted cash flow method to an arm's-length merger of a publicly traded company. However, the Court of Chancery noted that a different result may be warranted, where petitioners establish credible objections to the traditional efficient capital markets hypothesis endorsed by the Supreme Court through case-specific expert opinions supported by the weight of social science research. The Court of Chancery also highlighted important shortcomings when considering deal price, specifically the difficult task of backing out synergies and accounting for reduced agency costs.

Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd

No. 565, 2016 (Del. Dec. 14, 2017) (Valihura, J)

In this unanimous *en banc* decision, the Supreme Court of Delaware held that the Court of Chancery erred in giving no weight to Dell's pre-deal stock price or the deal price when determining the fair value in this appraisal proceeding. In the Court's view, "the market-based indicators of value—both Dell's stock price and deal price—have substantial probative value" and "deserved heavy, if not dispositive, weight." The Court cautioned the Court of Chancery to "be chary about imposing the hazards that always come when a law-trained judge is forced" to rely on discounted cash flow (DCF) analyses and "divergent partisan expert testimony."

Dissenting stockholders sought appraisal following a management buyout at $13.75 per share led by Dell's founder and affiliates of a private equity firm. An independent special committee negotiated with the buyout group, and evaluated alternatives through pre-signing and post-signing market checks that yielded rival bids from other PE firms. Throughout the process, Dell's founder expressed willingness to partner with any of the bidders and to supply as much of his own equity as needed to complete a going-private transaction. The Court of Chancery observed that the buyout resulted from a thorough sale process that "easily would sail through if reviewed under enhanced scrutiny."

Nevertheless, the Court of Chancery found that a confluence of factors justified assigning no weight to the deal price, and instead relied exclusively on its own DCF analysis, which resulted in a fair value of $17.62 per share. The Vice Chancellor concluded that both the market and the sale process did not reflect the company's intrinsic value: the market was too focused on Dell's short-term prospects and the participation of only financial bidders in the process resulted in a deal priced to clear internal rate of return hurdles. The Court also found that factors "endemic" to MBO go-shops cast doubt on the reliability of the deal price, because rival bidders could be discouraged from making topping bids due to perception that management had an informational advantage, fear that there was "no realistic pathway to success," or risk of overpaying for the company (*i.e.,* the putative "winner's curse").

In its appeal, Dell argued, and the Supreme Court agreed, that the Court of Chancery's "decision to give no weight to any market-based measure of fair value [ran] counter to its own factual findings." The evidence pointed to an efficient, rather than myopic, market for Dell shares. The Supreme Court observed that the lack of strategic bidders during the pre- and post-signing phases suggested that the deal price was not too low: if the deal price had substantially undervalued the company, then strategic competitors would have had strong incentives to bid. Furthermore, there was nothing in the trial record to suggest the presence of the putative features of MBOs that theoretically could undermine the reliability of deal price as evidence of fair value: Dell mitigated any informational asymmetry between the buyout group and other bidders by providing go-shop participants extensive due diligence and access to Dell's founder; and, contrary to any "winner's curse phenomenon," two rival bidders submitted competing proposals during the go-shop period.

This latest appraisal decision from the Supreme Court is consistent with its earlier ruling this year in *DFC Global Corp. v. Muirfield Value Partners, L.P.,* 172 A.3d 346 (Del. 2017), where it eschewed a bright-line presumption in favor of the deal price in appraisal actions, but nevertheless outlined conditions in which the deal price will be deemed strong evidence of fair value. The Court emphasized that the deal

process undertaken by Dell had many qualities that Delaware courts favor in giving the deal price substantial weight. The *Dell* opinion also highlights practical and policy pitfalls of the Court of Chancery's reliance on its own DCF analyses. The Supreme Court cautioned against constructing DCF analyses that attempt to reconcile "enormous valuation chasms caused by the over 1,100 variables" in competing DCF analyses when reliable market-based indicators are available.

The Supreme Court also addressed other issues in the appeal and the petitioners' cross-appeal. The Supreme Court found that, "for the most part, the trial court did not abuse its discretion" regarding certain features of the Court of Chancery's DCF analysis, although the Supreme Court questioned whether a DCF analysis remained necessary and appropriate on remand. The Supreme Court also reversed the trial court's allocation of attorney's expenses and fees among petitioners.

DFC Global Corp. v. Muirfield Value Partners, L.P.

No. 518, 2016 (Del. Aug. 1, 2017) (Strine, C.J.)

In this much-anticipated decision, the Delaware Supreme Court reversed and remanded the Court of Chancery's determination that the "fair value" of the stock of DFC Global Corporation ("DFC" or the "Company") was approximately 10% higher than the $9.50 per share price Lone Star Fund VIII (U.S.), LLP ("Lone Star"), a private equity firm, paid to acquire the Company in June 2014. While the Supreme Court declined to adopt a bright-line rule requiring complete deference to the deal price resulting from a robust, conflict-free sale process, the Court nonetheless concluded the Court of Chancery abused its discretion in according just one-third weight to the deal price. In reversing the fair value determination, the Court discredited two of the principal factors the Court of Chancery relied upon to justify its departure from the deal price.

DFC is a provider of alternative consumer financial services, predominately payday loans. In the spring of 2012, DFC retained a financial advisor to investigate a sale of the Company. The decision to sell the Company was spurred, in part, by increased regulatory scrutiny of the payday lending industry, high corporate leverage, and issues regarding management succession. Over the next two years, DFC was shopped through a robust sale process involving at least thirty-five financial sponsors and three strategic buyers. At the time of the sale process, however, the payday lending industry was undergoing a major regulatory overhaul, causing significant uncertainty with respect to the Company's future profitability. Due to such uncertainty, DFC repeatedly downwardly revised its financial projections throughout the sale process, causing potential buyers to lower their offers or drop out of the process entirely. On March 27, 2014, Lone Star revised its initial offer of $11.00 per share to $9.50 per share. DFC accepted Lone Star's revised offer, and the deal closed on June 13, 2014.

Following the announcement of the transaction, five DFC stockholders, who collectively owned 4,604,683 shares of DFC common stock, filed separate petitions for appraisal under 8 *Del. C.* § 262. The petitions were later consolidated into one action, which was tried in October 2015. The petitioners' expert calculated a fair value of $17.90 per share using a discounted cash flow model, while DFC's expert calculated a fair value of $7.94 per share based upon an approach that blended the results of a discounted cash flow model and a multiples-based comparable companies analysis. DFC also urged the Court of Chancery to consider the transaction price of $9.50 as the most reliable evidence of fair value.

In its post-trial decision, the Court of Chancery found that the sale process leading up to the acquisition of DFC was "robust" and "arm's-length." Acknowledging that it "frequently defers to a transaction price that was the product of an arm's-length process and a robust bidding environment," the Court of Chancery declined to do so here because the transaction was "negotiated and consummated during a time of significant company turmoil and regulatory uncertainty" and Lone Star, the private equity firm that ultimately acquired DFC, "focused its attention on achieving a certain internal rate of return and on reaching a deal within its financing constraints, rather than on DFC's fair value." The "significant company turmoil and regulatory uncertainty," according to the Court of Chancery, affected the reliability of management's projections and, consequently, the discounted cash flow and comparable companies analyses. Ultimately, after a rehearing, the Court of Chancery determined DFC's fair value was $10.30 per share, eighty cents per share more than the deal price, based on an equal weighting of "three

imperfect techniques": a discounted cash flow analysis, a comparable company analysis and the deal price.

On appeal, DFC urged the Supreme Court to adopt a bright-line rule that the deal price is the best evidence of fair value where, as here, it is the product of a robust, conflict-free sale process. The Supreme Court, however, declined to adopt such a bright-line rule, citing its decision in *Golden Telecom*, where the Court held that such an approach was inconsistent with the appraisal statute's requirement that the Court of Chancery consider "all relevant factors" in determining fair value. Because that statutory language remained unchanged and the Court could not specify the particular characteristics of a sale process that should require deference in all circumstances, the Supreme Court declined to overrule *Golden Telecom.*

The Supreme Court concluded, however, that the Court of Chancery abused its discretion in failing to accord greater weight to the deal price in light of the lower court's finding that the sale process was robust and conflict-free. In particular, the Court held that there was insufficient evidence in the record to support the Court of Chancery's decision to accord the deal price just one-third weight based on regulatory uncertainty and Lone Star's status as a financial buyer. According to the Supreme Court, there was no record evidence to suggest that the market—and market participants—could not price regulatory risk. Rather, referencing the company's receipt of lowered bids following downward revisions to management projections, the decision of some bidders to drop out of the process, and the inability of the company to refinance certain debt, the Court held that the record established that the market was "attuned to the regulatory risks facing DFC" and factored that risk into DFC's pricing.

Similarly, the Court concluded that the record did not support the Court of Chancery's conclusion that the deal price did not represent fair value because, as a financial sponsor, Lone Star sought to achieve a specific rate of return on its acquisition of DFC. The Court observed that a buyer's focus "on hitting its internal rate of return has no rational connection to whether the price it pays as a result of a competitive process is a fair one" particularly where additional factors, such as the absence of topping bidders, concerns about the company's credit rating, and the inability of the company to meet its own projections, support the fairness of the price paid by a financial sponsor.

The Supreme Court also held that the Court of Chancery erred by increasing the perpetuity growth rate it used in its discounted cash flow model from 3.1% to 4.1% after recognizing on reargument that it had used the wrong working capital figures in its original model. The Court of Chancery's revisions to the working capital figures would have resulted in the discounted cash flow model yielding a fair value figure lower than the deal price. However, the upward adjustment to the perpetuity growth rate resulted in the Court of Chancery arriving at a fair value similar to its original estimate of DFC's value. Citing the overly optimistic and uncertain nature of the out-years of the financial projections, the fact that the payday lending industry had already gone through a period of above-market growth, and the lack of any basis to conclude that DFC would sustain high growth beyond the projection period, the Supreme Court held that the Court of Chancery's adjustment to the perpetuity growth rate was not supported by the record.

Finally, the Court rejected the stockholder petitioners' argument that the Court of Chancery abused its discretion by relying in part on a comparable companies analysis instead of giving primary, if not sole, weight to the discounted cash flow model. Observing that "this was a rare instance where both experts agreed on the comparable companies the Court of Chancery used and so did several market analysts and others following the company," the Supreme Court held that giving weight to a comparable companies analysis was well within the Court of Chancery's discretion.

ACP Master, Ltd. v. Sprint Corp.

C.A. No. 8508-VCL (Del. Ch. July 21, 2017) (Laster, V.C.)

ACP Master, Ltd. v. Clearwire Corp.

C.A. No. 9042-VCL (Del. Ch. July 21, 2017) (Laster, V.C.)

In this post-trial opinion involving consolidated breach of fiduciary duty and statutory appraisal actions, the Court of Chancery held that the fair value of Clearwire Corp. ("Clearwire") was $2.13 per share, significantly lower than the $5 per share deal price Sprint Nextel Corporation ("Sprint") paid in July 2013 to acquire the 49.8% stake in Clearwire that it did not already own. The Court also found that Sprint did not breach the fiduciary duties it owed as controlling stockholder because the merger was entirely fair to Clearwire's minority stockholders.

Sprint had initially offered a buyout price of $2.97 per share, but negative stockholder reaction and a subsequent bidding war with Dish Network Corp ("DISH") caused Sprint to agree to raise its offer to $5.00 per share. Ultimately, a special committee recommended that the stockholders approve Sprint's final offer at $5.00 per share, and 70% of Clearwire's unaffiliated stockholders voted in favor of the merger. Thereafter, Aurelius Capital Management, LP and certain affiliates ("Aurelius") filed a plenary lawsuit contending that the merger resulted from Sprint's breach of its fiduciary duties as a controlling stockholder of Clearwire and arguing that the stock was worth over $16.00 per share. Aurelius also filed a statutory appraisal proceeding. The Court consolidated and tried both cases.

The Court first considered the fiduciary duty claims. Because the transaction involved a controlling stockholder, the Court concluded that entire fairness was the applicable standard of review, with defendants bearing the burden of proving that the transaction was entirely fair. Although the Court found that "multiple instances of unfair dealing" occurred in the first phase of the merger process—*i.e.*, related to the deal priced at $2.97 per share—the Court held that DISH's subsequent higher bids and the ensuing bidding war "changed the landscape so substantially as to render immaterial the instances of unfair dealing that took place during the first phase" of the sale process. Thus, the Court held that Sprint carried its burden in showing that the eventual $5.00 per share merger price and the process that led to it were entirely fair, despite Sprint's unfair dealing during the first phase of the transaction.

After finding the merger to be entirely fair, the Court turned to the appraisal claims. Because neither party argued that the Court should give weight to the deal price, and because the merger price reflected synergies not properly within the scope of an appraisal valuation, the Court declined to utilize the merger price as evidence of fair value. Instead, the Court relied exclusively on the Discounted Cash Flow ("DCF") analysis prepared by Sprint's expert to determine the fair value of Clearwire's stock. The Court found the valuation of Sprint's expert superior to that of Aurelius' expert in its choice of future cash flow projections, perpetuity growth rates, discount rates, and its valuation of the unused portion of Clearwire's spectrum.

The Court adopted the cash flow projections used by Sprint's expert because those projections were prepared in the ordinary course of business by Clearwire's management. In contrast, Aurelius's expert relied on unrealistic projections created by Sprint's management that, according to the Court, failed to reflect Clearwire's operative reality at the time of the merger.

The Court likewise approved of Sprint's use of a perpetuity growth rate at 3.35%, which represented the midpoint of inflation and GDP growth. Noting that the discount rates between the two determinations accounted for less than 1% of their difference in valuation results, the Court adopted Sprint's discount rate with minimal discussion and for the sake of consistency with its acceptance of the other components of Sprint's DCF analysis.

Lastly, the Court rejected Aurelius's valuation of Clearwire's 40MHz of unused spectrum in favor of Sprint's determination of the unused spectrum's value. The Court found Sprint's valuation more accurate because it relied on figures implied by the price offered in an earlier proposal from DISH to purchase 40MHz worth of Clearwire's capacity, which reflected what a buyer was willing to spend on the unused spectrum.

In re Appraisal of GoodCents Holdings, Inc.

C.A. No. 11723-VCMR (Del. Ch. June 7, 2017)
(Montgomery-Reeves, V.C.)

In this memorandum opinion, the Court of Chancery granted petitioners' motion for partial summary judgment in an appraisal action stemming from a 2015 merger, holding that a merger transaction triggered a voting right but not the payment of a liquidation preference to the preferred stockholders of GoodCents Holdings, Inc. ("GoodCents" or the "Company"). As a result, the Court found that petitioners, who owned common stock in GoodCents, were entitled to their proportionate share of the fair value of the Company, which should be allocated pro rata among GoodCents's common and preferred stockholders.

The common stockholders of GoodCents included two individuals holding collective voting power of 18.21%, while the holders of preferred stock held the remaining 81.79%.

Following the affirmative vote of all of the Company's preferred stockholders, GoodCents consummated a merger in 2015 providing for $57 million in cash consideration. The Company's certificate of incorporation (the "Certificate") included a liquidation preference of approximately $73 million payable to holders of preferred stock if certain events occurred (the "Liquidation Preference"). The Company determined that the merger triggered the Liquidation Preference. As a result, the preferred stockholders received the entire $57 million cash consideration, while the common stockholders received nothing. Petitioners argued that they were entitled to a pro rata distribution of the Company's fair value since, under the plain language of the Certificate, the merger did not trigger the Liquidation Preference.

The Court conducted an analysis of relevant provisions in the Certificate to determine the rights of preferred stockholders. It reviewed the language contained in the Certificate providing for the Liquidation Preference, which stated at Section B.6.a that, "[i]n the event of any voluntary or involuntary liquidation, dissolution or winding up of the corporation," the Preferred Stockholders were entitled to their Liquidation Preference before any compensation is paid to the holders of common stock. The Certificate further provided in Section B.6.c that "[w]ithout the affirmative vote of the holders of a majority of the [Preferred Stockholders], the corporation shall not ... effect any merger or consolidation ... unless the agreement or plan of merger ... shall provide that the consideration payable to the stockholders ... shall be distributed to the holders of capital stock of the corporation in accordance with [the Preferred Stockholders' Liquidation Preference]." Respondents argued that the language cited by petitioners established that the Liquidation Preference was triggered by the merger. The Court disagreed, reasoning that the plain language of the Certificate granted a voting right to the preferred stockholders in the context of a merger, but not a right to receive the Liquidation Preference.

In so holding, the Court first determined that the plain language of Section B.6.c merely provided a "blocking right" to the Company's preferred stockholders in the context of a merger that fell away if the terms of the merger agreement satisfied the $73 million Liquidation Preference. The Court then noted that, while Section B.6.a of the Certificate "expressly requires payment" of the Liquidation Preference in the case of a liquidation, dissolution or winding up of the Company, parallel language providing for the payment of the Liquidation Preference in the context of a merger was "notably absent" from Section B.6.c. The Court also drew an analogy to *In re Appraisal of Ford Holdings, Inc. Preferred Stock,* 698 A.2d 973 (Del. Ch. 1997), where former Chancellor Allen considered "nearly identical" language contained in a company's certificate of designations, and held that the language at issue only granted the preferred stockholders a voting right, and not a right to receive a specific economic benefit.

Finally, petitioners argued, without opposition, that the voting rights of preferred stockholders could not be independently valued and used to dilute the common stock's value in an appraisal proceeding. The Court agreed, holding that, since the preferred stockholders were not entitled to receive their Liquidation Preference in the merger, petitioners were entitled to a proportionate share of GoodCents's fair value, "considering the Preferred Stock on an as-converted basis."

In re Appraisal of SWS Group, Inc.

C.A. No. 10554-VCG (Del. Ch. May 30, 2017) (Glasscock, V.C.)

In this post-trial appraisal opinion, Vice Chancellor Glasscock, relying on a discounted cash flow analysis, held that the fair value of SWS Group, Inc. ("SWS") at the time of its January 2015 merger with a wholly-owned subsidiary of its creditor Hilltop Holdings, Inc. ("Hilltop" and, together with SWS, "Respondents") was $6.38 per share, a substantial discount to the $6.92 per share consideration SWS stockholders received in the transaction. The Court's determination, was, in the Vice Chancellor's estimation, "not surprising" given that the deal was "a synergies-driven transaction" in which the acquirer shared value arising from the merger with SWS.

The Court gave two primary reasons for not deferring to the deal price. First, neither party relied on the deal price to establish fair value. Petitioners argued that the sales process was so flawed that deal price was irrelevant, while Respondents argued that deal price was improper because it included large synergies inappropriate to statutory fair value. Second, the Vice Chancellor determined that impairments to the sales process, including the probable effect on the deal price of the existence of a credit agreement between SWS

and Hilltop and Hilltop's exercise of partial veto power over competing offers, rendered the merger price an unreliable indicator of fair value.

The Vice Chancellor found the petitioner's expert comparable companies analysis unreliable and gave it no weight because the comparable companies selected by the expert "diverge[d] in significant ways from SWS in terms of size, business lines, and performance" and thus were not truly comparable to SWS.

In creating its own discounted cash flow analysis, the Court began with SWS management's cash flow projections. The Court noted that management routinely prepared three-year projections and rejected petitioners' expert's extension of the projections for an additional two years on the theory that the company would not reach a "steady state" in three years and, therefore, applying a terminal period after five years would better capture its future performance as unsupported by the evidence.

The Court made a number of determinations regarding certain DCF inputs. First, it addressed whether a 2014 warrant exercise should be considered as part of the company's "operative reality" at the time of the merger and whether any excess regulatory capital SWS held as a result should be distributed in the valuation model. On the first point, the Court held that the warrant exercise was part of the company's operative reality because the warrants were exercised before the merger to enable holders to vote for the transaction. On the second point, the Court held that the resulting capital change would not lead to a distribution of excess regulatory capital to the stockholders. In support of this latter conclusion, the Court noted that management's projections contemplated the warrant exercise in 2016 but not a resulting distribution. The warrant exercise did, however, result in a reduction to the company's interest expense and, therefore, a resulting increase to management's projections of net income.

Second, the Court adopted Respondents' proffered terminal growth rate, 3.35%, the midpoint between the long-term expected inflation rate (2.3%) and the long-term expected economic growth rate of the economy at large (4.4%).

Third, the Court made determinations related to the parties' use of the Capital Asset Pricing Model to calculate the cost of equity. The parties agreed that the risk free rate of return was 2.47%, but disagreed on the equity risk premium, equity beta and size premium.

With regards to the equity risk premium, the Court adopted petitioners' use of the supply-side ERP, finding no basis to deviate from the Court of Chancery's trend of employing the supply-side instead of a historical ERP.

The Court also adopted petitioners' beta, which was derived using multiple data points including by reference to comparable company returns. The Court rejected Respondents' use of a two-year weekly lookback from the date of Hilltop's initial offer because it covered times where a "merger froth" and corresponding volatility were likely reflected in the trading and pricing of SWS stock.

Both parties' experts employed Duff & Phelps as the source of their size premium, but they disagreed on which decile SWS fell within. The Court held that both petitioners and Respondents presented persuasive evidence for their position and split the difference down the middle, using the mid-point of the expert's approaches.

After reaching the foregoing determinations on the inputs to the DCF analysis, the Court held that the fair value for SWS shares at the time of the merger was $6.38 per share.

In re Appraisal of PetSmart, Inc.

Consol. C.A. No. 10782-VCS (Del. Ch. May 26, 2017) (Slights, V.C.)

In this post-trial appraisal opinion arising from a going-private transaction in which the public stockholders of PetSmart Inc. ("PetSmart") were cashed out for $83 per share, Vice Chancellor Slights held that the deal price was the best indicator of the fair value of PetSmart's shares as of the closing of the merger. In reaching this conclusion, the Vice Chancellor declined to adopt any of petitioners' proffered discounted cash flow analyses.

The Court approached the parties' competing positions by reducing them to the following three questions: "(1) was the transactional process leading to the [m]erger fair, well-functioning and free of structural impediments to achieving fair value for [PetSmart]; (2) are the requisite foundations for

the proper performance of a DCF analysis sufficiently reliable to produce a trustworthy indicator of fair value; and (3) is there an evidentiary basis in the trial record for the Court to depart from the two proffered methodologies for determining fair value by constructing its own valuation structure?"

The Court first determined that the merger price was a reliable indicator of fair value because "the process employed to facilitate the sale of PetSmart, while not perfect, came close enough to perfection to produce a reliable indicator of PetSmart's fair value." PetSmart considered and explored all of its strategic options, including remaining a standalone company. It "announced to the world" that it was pursuing strategic alternatives including a potential sale, putting "the whole universe of potential bidders" on notice. Its financial advisor, J.P. Morgan Securities, LLC, contacted twenty-seven parties, including three potential strategic acquirers. Fifteen of those parties signed non-disclosure agreements and thirteen of them also received in-person presentations from management. Ultimately, PetSmart received indications of interest from five bidders, which resulted in three final bids, including a joint-bid between two of the five initial bidders. PetSmart's fully-informed stockholders then overwhelmingly approved the merger. The Court found no evidence that any bidder was favored. Although the PetSmart board determined not to include Petco, PetSmart's primary competitor, during that process—a decision the Court found to be within the board's business judgment—PetSmart remained open to including Petco in the process if it made a real indication of interest. It did not. Additionally, no party made a topping bid despite positive uptrends in PetSmart's business before the merger closed.

In determining that the merger price was a reliable indicator of PetSmart's fair value as of the time of the merger, the Court rejected, among other things, petitioners' argument that a financial bidders' "LBO model" rarely if ever will produce a fair value. The Court noted that the private equity bidders did not know whether they were bidding against strategic bidders or other financial sponsors and that various financial sponsors made different bids. The Court stated as follows: "while it is true that private equity firms construct their bids with desired returns in mind, it does not follow that a private equity firm's final offer at the end of a robust and competitive auction cannot ultimately be the best indicator of fair value for the company."

The Court also rejected the petitioners' argument that a three-month period between the signing of the merger agreement and closing rendered the deal price stale. The Court noted that PetSmart's business had shown positive uptrends prior to the merger, but also considered post-closing evidence of PetSmart's performance and determined that the positive uptrends prior to the merger were short-term and not indicative of a long-term trend affecting the company's going concern value as of the time of the merger.

The Court acknowledged that a DCF analysis is often considered the "gold standard" of valuation tools, but did not employ one after determining that PetSmart's management projections were not a reliable forecast of PetSmart's future performance. First, management did not have a history of creating long-term projections. Second, the projections were not created in the normal course and were instead created to aid in the auction process—and under intense pressure from the PetSmart board to be aggressive, with the expectation that the projections would be discounted by potential bidders. Third, the Court noted, even management's short-term projections proved historically unreliable.

The Court also determined that there was no reliable basis on which to construct its own projections given the lack of reliable projections and rejected petitioners' attempts to provide a DCF analysis based on alternative projections. Thus, the Court held that the merger price represented the fair value of PetSmart's stock as of the date of the merger.

In re Appraisal of DFC Global Corp.

C.A. No. 10107-CB (Del. Ch. July 8, 2016) (Bouchard, C.)

In this post-trial statutory appraisal decision, Chancellor Bouchard held that the fair value of the stock of DFC Global Corporation ("DFC" or the "Company") was $10.21, 71 cents per share higher than the $9.50 per share deal price in the Company's June 2014 sale to private equity buyer, Lone Star Fund VIII (U.S.), LLP ("Lone Star"). To determine fair value, Chancellor Bouchard used a blend of three common valuation methodologies—discounted cash flow ("DCF") analysis, multiples-based comparable company analysis, and the deal price—concluding that an equal weighing of the three was the most reliable determinant of fair value.

In April 2012, DFC engaged Houlihan Lokey Capital Inc. to investigate a sale of the Company to a financial sponsor. The decision to sell the Company was spurred, in part, by increased regulatory scrutiny, high corporate leverage, and questions regarding management succession. Over the next two years, DFC was shopped through a robust sales process in which forty-three financial sponsors and three potential strategic buyers were contacted. In February 2014, Lone Star offered to buy DFC for $11.00 per share. Lone Star lowered its offer to $9.50 per share after DFC disclosed downward revisions to its financial projections based on regulatory uncertainty. DFC accepted Lone Star's revised offer, and the deal closed on June 13, 2014.

Following the announcement of the transaction five stockholders, representing 4,604,683 shares, filed petitions for appraisal under 8 *Del. C.* § 262. The Court consolidated the petitions and held a three-day trial in October 2015 featuring a battle of financial experts. The petitioners' expert calculated a fair value of $17.90 per share using a DCF model based on management's projections. DFC's expert blended two valuation methodologies, a DCF model and a multiples-based comparable companies analysis, to reach a much lower value of $7.94 per share. DFC also urged the Court to consider the transaction price of $9.50 as the most reliable evidence of fair value.

The Court acknowledged that it has broad discretion in an appraisal proceeding to consider *all relevant factors* when determining fair value and the discretion to use the valuation methods it deems appropriate, including the parties' proposed valuation frameworks, or one of the Court's own making. The Court made clear, however, that it must limit its valuation to the firm's value as a going-concern and exclude the speculative elements of value that may arise from the accomplishment or expectation of the merger. With that legal framework in place, the Court began its analysis of the fair value of DFC's stock.

Observing that the transaction "was negotiated and consummated during a period of significant company turmoil and regulatory uncertainty, [which] called into question the reliability of the transaction price as well as management's financial projections," the Court determined that a blend of the "three imperfect techniques" was the most reliable determinant of fair value. The Court found that the series of adjustments to DFC's financial projections—upon which both the Court's and the expert's DCF models were based—rendered a DCF analysis less than fully reliable. The Court acknowledged that while it frequently defers to the transaction price when it is the product of an arm's-length process and a robust bidding environment, the transaction price is "reliable only when the market conditions leading to the transaction are conducive to achieving a fair price." Lone Star purchased the Company at a time when DFC's performance was declining, with its future performance depending on the outcome of regulatory decision-making that was out of the Company's control. The Court found that these factors made the transaction price less than fully reliable as an indicator of DFC's fair value.

Although each valuation method suffered from various limitations stemming from the regulatory uncertainty that the Company faced, the Court concluded that each method provided meaningful insight into DFC's fair value. For this reason, the Court decided to weigh each valuation method equally, arriving at a price of $10.21 per share.

In re Appraisal of Dell Inc.

C.A. No. 9322-VCL (Del. Ch. May 31, 2016) (Laster, V.C.)

In this memorandum opinion, the Delaware Court of Chancery resolved the long-running litigation over the buyout of Dell Inc. ("Dell" or the "Company"), valuing the company at nearly $4 per share over the transaction price. Vice Chancellor Laster held, after a full trial on the merits, that the fair value of Dell was 28% higher than the price paid for it by founder Michael Dell and Silver Lake Partners, even though the deal price was a nearly 30% premium over Dell's market price. The Court did so despite acknowledging that, in at least five decisions, the Court of Chancery "has found the deal price to be the most reliable indicator of the company's fair value, particularly when other evidence of fair value was weak," and that Dell's sale process "easily would sail through if reviewed under enhanced scrutiny."

In June 2012, Dell's stock price had shrunk to approximately $12 per share. Mr. Dell, believing that the market had undervalued the Company, approached the Dell board about a possible management buyout. The Dell board formed a special committee, with full powers to negotiate on behalf of the Company and to consider other strategic

alternatives or other matters it determined to be advisable. In July 2012, management presented its projections to the board, projecting the Company was worth $25 billion more than the then current market capitalization of $15 billion. Management subsequently revised its projections downward in September 2012. The special committee's financial advisors prepared a stand-alone valuation of Dell at the time that included a DCF range of $20 to $27 per share using the September projections, and a DCF range of $15.25 to $19.25 per share using the Street's consensus case. It also stated that a financial buyer applying an LBO pricing model at 3.1x leverage and assuming a 20% five-year IRR would likely pay a price of approximately $14 per share. KKR and Silver Lake submitted initial proposals, but KKR dropped out following Dell's underperformance in third quarter 2013. Silver Lake then submitted a proposal of $12.70 cash per share, which it increased to $12.90. The special committee set a target price at $13.75 per share, and, on February 6, 2013, accepted an offer from Silver Lake of $13.65 cash per share with Mr. Dell rolling over his shares at a lower per share valuation with an additional cash investment. The proposed deal would result in Mr. Dell owning approximately 75% of the Company following the transaction.

The proposed transaction with Mr. Dell included a 45-day go-shop period. Dell's special committee approached 60 potential strategic acquirers, which resulted in Carl Icahn proposing a leveraged recapitalization bid and Blackstone proposing $14 cash per share (which was later withdrawn). Silver Lake raised its offer to $13.75 cash per share plus a cash dividend immediately preceding the merger of $0.13 per share. The special committee and Dell's board approved the transaction and Dell's unaffiliated shareholders voted in favor of the transaction. The merger closed on October 29, 2013, and certain Dell shareholders exercised their appraisal rights. A full trial on the merits was subsequently held.

After the trial, the Court ruled that the sale price was not a reliable indicator of fair value. The Court specifically indicated that three factors contributed to the deal price being below fair value: (1) the use of an LBO pricing model to determine the original merger price, (2) the "compelling" evidence of a significant "valuation gap" between the long-term value of Dell in the view of Dell's management and the market price of the Dell stock, and (3) the lack of "meaningful" pre-signing competition. First, the Court began by noting that because the transaction was a management buyout "management's additional and conflicting role as buyer [] present different concerns than true arms' length transactions." The Court was concerned that, because the only active bidders were financial buyers, as opposed to strategic buyers, the transaction price reflected the constraints of an "LBO pricing model" wherein financial bidders focus only on short term internal rates of return. In the Court's view, the Dell special committee "as a practical matter negotiated without determining the value of its best alternative to a negotiated acquisition" because an LBO pricing model solves backwards from a desired internal rate of return. The Court found that fair value under the appraisal statute requires more long term considerations, such as asset value and prospective earnings. Second, as a result, the Court found evidence of a "valuation gap between the market's perception and the Company's operative reality." A major consideration, in the Court's view, against the "short-term, quarter-by-quarter results" focus of an LBO pricing model was the Company's recent $14 billion in investments that had not yet generated their anticipated results. Third, the Court found that there existed limited pre-signing competition for the Company. The Court opined that even though the special committee was empowered to say no to Silver Lake's offer, the special committee lacked the meaningful threat of an alternative deal.

The Court then held that problems existed in the post-signing go-shop phase that resulted in a deal price below fair value. These problems included the size and complexity of Dell as a Company, the "winner's curse" of asymmetrical information between insiders and potential bidders, and Mr. Dell's personal value to the Company. As a result, the Court concluded that Dell failed to establish by a preponderance of the evidence that the outcome of the sale process offered the most reliable evidence of fair value. Even considering all these factors, the Court found the outcome of the sale process sufficiently probative to rule out the petitioners' claim that Dell shares were worth $28.61 (more than twice the deal price).

The Court then turned to both sides' DCF analysis generated by their respective experts. The parties' experts' different DCF analyses resulted in values that differed by 126%, which was primarily caused by the different projected cash flows used. The Court ultimately determined to use its own inputs, based on forecasts from the Company's expert, and conduct its own DCF analysis, which resulted in a price of $17.62 per share.

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