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EXPERT ANALYSIS

CKx Decisions Reveal Developments In Delaware Stock Appraisal Rules

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In *Huff Fund Investment Partnership v. CKx Inc.*,[1] the Delaware Court of Chancery confirmed that, under Delaware law, the merger price may be a reliable indicator of — or even the primary factor in determining — the fair value of corporate stock in a statutory appraisal proceeding.[2] In a subsequent ruling in the same case, the court denied the respondent corporation's motion requesting that the court order the petitioning stockholders to accept payment of the undisputed portion of the value of its stock in order to stop, in part, the running of interest at the legal rate, finding the relief sought to be incompatible with the appraisal statute.[3]

THE APPRAISAL STATUTE

Under Section 262 of the Delaware General Corporation Law, stockholders who meet certain requirements are entitled to an appraisal by the Chancery Court of the "fair value" of their shares of stock.[4] Fair value in the context of an appraisal proceeding is the "value to a stockholder of the firm as a going concern, as opposed to the firm's value in the context of an acquisition or other transaction."[5] In determining fair value, "the court shall take into account all relevant factors."[6] "Only the speculative elements of value that may arise from the accomplishment or expectation of the merger," such as any synergistic value, should be excluded from a fair value calculation on the date of the merger.[7]

Section 262 vests the court with "significant discretion" to consider the data and use the valuation methodologies it deems appropriate.[8] For example, the court has the discretion to "select one of the parties' valuation models as its general framework, or fashion its own, to determine fair value[.]"[9] The court may consider "proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court."[10]

Prior to its 2007 amendment, Section 262 provided the Chancery Court with "a significant amount of discretion to determine the interest to which a petitioner was entitled,"[11] authorizing the court to "consider all relevant factors" and determine "a fair rate of interest, if any, to be paid upon the amount determined to be the fair value."[12] Following the 2007 amendment, Section 262(h) provides, in pertinent part:

> Unless the court in its discretion determines otherwise *for good cause shown*, interest from the effective date of the merger *through the date of payment of the judgment* shall be compounded quarterly and shall accrue at 5 percent over the Federal Reserve discount rate (including any surcharge) as established from time to time during the period between the effective date of the merger and the date of payment of the judgment.[13]

The statute thus allows the court to deviate from the prescribed rate of interest only for good cause shown.[14]

RELIANCE ON NEGOTIATED MERGER PRICE

Under Delaware law, "fair value" for purposes of appraisal generally is equated with the corporation's stand-alone value, "rather than its value to a [particular] third party as an acquisition."[15] "If, however, the transaction giving rise to the appraisal resulted from an arm's-length process between two independent parties, and if no structural impediments existed that might materially distort 'the crucible of objective market reality,' a reviewing court should give substantial evidentiary weight to the merger price as an indicator of fair value."[16]

Thus, historically, the court has relied on the merger price itself in certain cases as evidence of fair value, "so long as the process leading to the transaction is a reliable indicator of value and merger-specific value is excluded."[17] This reliance is consistent with the premise that the determination of fair value is what would be paid in an arm's-length transaction.[18]

Although the court's ability to rely on the merger price as evidence of fair value in the appropriate context appeared well settled, in *Golden Telecom Inc. v. Global GT LP*,[19] the respondent corporation requested that the Delaware Supreme Court "adopt a standard requiring conclusive or, in the alternative, presumptive deference to the merger price in an appraisal proceeding."[20] The state high court rejected this proposed new rule, which would have divested the Chancery Court of its discretion in determining fair value, opining as follows:

Section 262(h) unambiguously calls upon the Chancery Court to perform an independent evaluation of "fair value" at the time of a transaction.

> Section 262(h) unambiguously calls upon the Court of Chancery to perform an independent evaluation of "fair value" at the time of a transaction. It vests the chancellor and vice chancellors with significant discretion to consider "all relevant factors" and determine the going concern value of the underlying company. Requiring the Court of Chancery to defer — conclusively or presumptively — to the merger price, even in the face of a pristine, unchallenged transactional process, would contravene the unambiguous language of the statute and the reasoned holdings of our precedent. It would inappropriately shift the responsibility to determine "fair value" from the court to the private parties. Also, while it is difficult for the chancellor and vice chancellors to assess wildly divergent expert opinions regarding value, inflexible rules governing appraisal provide little additional benefit in determining "fair value" because of the already high costs of appraisal actions. Appraisal is, by design, a flexible process. Therefore, we reject [respondent's] contention that the vice chancellor erred by insufficiently deferring to the merger price, and we reject its call to establish a rule requiring the Court of Chancery to defer to the merger price in any appraisal proceeding.[21]

It is important to emphasize that the Supreme Court did not suggest that the merger price could no longer be considered in determining fair value (as it had been numerous times in the past). Rather, the court simply refused to create a new rule dictating that the Chancery Court must defer to the merger price.

Following the Supreme Court's ruling in *Golden Telecom*, two Chancery Court appraisal decisions refused to give any weight to the merger price.[22] This led some practitioners to view the merger price as "irrelevant," "off the table" and not reliable evidence of fair value in appraisal proceedings.[23] Yet, neither decision stated that Delaware law had changed or that the Chancery Court could no longer rely on the negotiated merger price as an indicator of fair value.

Rather, in each case, the court simply held that the merger price was not a reliable indicator of fair value based on the particular facts of the case. One of the cases, *In re Orchard Enterprises Inc.*,[24] was a going-private merger between the respondent corporation and its controlling stockholder, and the court was not convinced, based on the trial record, that the company had been shopped adequately to third parties.[25]

In the other case, *Merion Capital LP v. 3M Cogent Inc.*,[26] the respondent corporation did not seek to use the merger price as evidence of fair value and did not attempt to adjust the merger price to remove any synergistic value from the merger.[27] Thus, each case is readily distinguishable from the cases in which the merger price was found to be a reliable indicator of fair value.

As explained below, any doubt that the negotiated price may be relied upon by the Chancery Court of determining fair value was eliminated by the recent decision in *Huff Fund v. CKx*.[28]

THE APPRAISAL OF CKX STOCK

Prior to its acquisition by affiliates of Apollo Global Management LLC, CKx Inc. was a publicly traded entertainment company listed on Nasdaq. The company's most significant property was 19 Entertainment, which owned the rights to the top-rated show on television, "American Idol." By 2011, revenues from the show made up 60 percent to 75 percent of CKx's cash flow, but the show's ratings had declined for five straight seasons and the distribution agreement with Fox was set to expire. Because Fox held a perpetual license to renew its exclusive contract to broadcast "American Idol," CKx could not threaten to shop the show to other networks and thus had limited negotiating leverage.

In 2007, CKx's largest stockholder offered to buy out the public stockholders of the company for $13.75 per share. However, the deterioration of credit conditions in the overall market leading up to and during the financial crisis made it uneconomical to consummate the transaction. Nonetheless, the offer suggested to CKx management and the market at large that the company was for sale, and, thereafter, the company executed confidentiality agreements with several potential acquirers. No potential buyer made an offer for CKx, however, and the possible sale disrupted the company's acquisition strategy. Consequently, in October 2010, CKx took down "the figurative 'for sale' sign."

Following the state Supreme Court's ruling in Golden Telecom*, two appraisal decisions refused to give any weight to the merger price.*

The company's announcement that it no longer was for sale had the ironic effect of renewing the interest of private equity buyers. In spring 2011, Apollo and two other financial sponsors submitted offers ranging from $4.50 to $5 per share for CKx, leading the company's board of directors to decide to again pursue a possible sale. The board retained a financial adviser to solicit interest from additional parties and to run an auction among the interested buyers.

Although a dozen potential acquirers were contacted, ultimately, only Apollo and one other party submitted bids; Apollo bid $5.50 per share; Party B bid $5.60 per share. Despite the slightly lower price, the board accepted the Apollo bid because Party B's financing was not certain and Party B's bid did not grant CKx the right to seek specific performance. The subsequent class-action litigation settled in exchange for supplemental disclosures and a slight reduction in the termination fee. The merger closed in June 2011.

Huff Fund Investment Partnership, among others, petitioned for appraisal in the Chancery Court. Following trial, the court held that the $5.50-per-share price paid by Apollo was the most reliable indicator of fair value. The court rejected both parties' expert valuations.

The court explained that the wide gulf between the expert valuations — the petitioners' expert valued CKx stock at $11.02 per share, while the company's expert valued the stock at $4.41 per share — was the result of just a few different assumptions, the most significant of which were the different cash flow projections used by the experts for their respective discounted cash flow analyses.

Specifically, in connection with expressions of interest from potential acquirers and the auction process, CKx management prepared five-year projections that included assumptions — later described as "optimistic" and a "marketing ploy" to produce a higher bid from potential acquirers — that the company could renegotiate its "American Idol" contract with Fox to generate an additional $20 million of revenue per year.

The petitioners' expert relied on the management projections, while the company's expert disregarded the management projections and assumed that the fees from Fox would grow at 4 percent per year for five years. The court found that both of these methods were unreliable.

The court explained that "[t]he result of the Fox contract negotiations would be a one-time, unpredictable, irreversible, and immitigable increase or decrease in the fixed licensing fee," and, unlike normal cash flow projections, would be determined by "a single superseding event beyond the company's control involving idiosyncratic actors making decisions that would have a large effect on the company's future value." Because the court had "little confidence in the reliability of using *or* excluding the estimated $20 million increase in revenues under the to-be-negotiated American Idol contract," it held that "a DCF analysis is not the appropriate method of valuation in this case."[29]

The Chancery Court's recent rulings in Huff Fund Investment Partnership v. CKx Inc. *are important precedents for future appraisal cases.*

The court similarly rejected the "guideline" companies and transactions analyses performed by the petitioners' expert, because the expert himself admitted at trial that the "guideline" companies and transactions were not at all comparable to CKx. The court noted that the petitioners' expert testified that "he found no companies he could describe as 'comparable' to CKx, which was why he labeled his analyses as consisting of 'guideline' public companies and acquisitions," rather than as "comparable" companies and acquisitions. As such, the court determined that it could not rely on this valuation method either.

"In the absence of comparable companies or transactions to guide a comparable companies analysis or a comparable transactions analysis, and without reliable projections to discount in a DCF analysis," the court decided to "rely on the merger price as the best and most reliable indication of CKx's value." The court rejected the petitioners' argument that the Supreme Court's decision in *Golden Telecom* and the Chancery Court decisions in *3M Cogent* and *Orchard* "stand for the proposition that merger price is now irrelevant in an appraisal."

"The Supreme Court's holding [in *Golden Telecom*] is clear," the vice chancellor wrote. "The Court of Chancery has a statutory mandate to consider 'all relevant factors' in conducting an appraisal proceeding, and, accordingly, the Supreme Court declined to impose a presumption systematically favoring one of those factors — merger price — over the others. The [petitioners'] position here, that I should *ignore* the merger price in appraising CKx, is in my view directly at odds with the holding and rationale of *Golden Telecom*."[30]

The court distinguished *3M Cogent* because, in that case, there was a reliable DCF analysis and the company did not seek to use the merger price as an indicator of value. In contrast, here, there was no reliable DCF analysis and the company "ha[d] consistently pointed to the merger price as supporting its valuation."

The court distinguished the *Orchard* case on the ground that, in that case, "the only evidence that a merger price was the result of 'market' forces was a post-signing go-shop period (which failed to produce competing bids)." In contrast, the CKx board and its financial adviser "successfully instigated a bidding war" for the company "and also canvassed the market for other potentially interested bidders." The court also noted prior case law where it "decided to place 100 percent weight on the merger price."

As such, the court held that, in this case, "the merger price is the most reliable indicator of value." Because "the objective of an appraisal is to determine the *going-concern value* of the target company's equity,"[31] and because there was limited evidence in the record concerning any synergies that Apollo would realize from its acquisition of CKx — the value of which must be excluded from a fair value determination — the court allowed the parties the opportunity to provide additional evidence on this limited issue.

CKX'S MOTION TO STOP INTEREST ACCRUAL

While the parties still were in the process of supplementing the record on whether the $5.50-per-share merger price included synergies that should be excluded from going-concern value (and whether the merger price failed to account for opportunities that should be included in going-concern value), the company filed a "motion to stop the accrual of interest," requesting that the court order the petitioners to accept an unconditional tender of $3.63 per share, which represented the company's expert's base case scenario for valuing CKx.[32]

In other words, by the motion, the company agreed that CKx was worth at least $3.63 per share and that it was willing to tender that amount to stop the accrual of interest on that payment at the statutory legal rate of 5.75 percent, five percent above the Federal Reserve discount rate. Despite the company agreeing that the petitioners would not be required to return the tendered amount and even offering to indemnify the petitioners for any negative tax consequences incurred as a result of the partial payment, the court denied the company's motion.

The court was sympathetic to the company's argument that, when market rates of return are low, "a near risk-free return 5 percent above the Federal discount rate may penalize a respondent corporation, and may create perverse litigation and investment incentives, including encouragement of litigation of cases without significant potential for an award above the merger consideration, and even arbitrage of appraisal claims," agreeing that "compared with fault-based litigation, the opportunities for rent-seeking in appraisal actions are comparatively high."

However, the court found the relief requested by the company to be "incompatible" with the Delaware Legislature's intent in revising the appraisal statute.

The court explained that, prior to its 2007 amendment, Section 262(h) provided the Chancery Court significant discretion to determine "a fair rate of interest, if any" to award a petitioner.

However, following its amendment, Section 262(h) directs the court to award interest except "*for good cause shown*, … from the effective date of the merger *through the date* of payment of the judgment." [33] Because "good cause" generally has been invoked only in cases of bad faith or vexatious litigation, the court concluded that it retained only "limited" discretion to determine an alternative award of interest following the 2007 amendment to the statute.

Further, because the revised Section 262(h) expressly requires an award of interest "through the date of payment of 'the judgment,'" the court determined that it had no discretion to enter the order requested by the company, stating that "[w]ith respect to the … accrual period in connection with statutory appraisal, the General Assembly has made its call."

Accordingly, because "the relief sought [was] incompatible with the statute," the court denied the company's motion to stop the accrual of interest.

CONCLUSION

The Chancery Court's recent rulings in *Huff Fund* are important precedents for future appraisal cases. In its first ruling, the court confirmed that the merger price may be a reliable indicator — and sometimes may even be the *most* reliable indicator — of the fair value of stock in an appraisal case, thereby resolving an issue of debate among practitioners and academics following the state Supreme Court's *Golden Telecom* decision in 2010. In its subsequent ruling, the court, while recognizing the potentially perverse litigation incentives in appraisal actions, held that Section 262(h) does not allow it the discretion to stop the accrual of interest by ordering the petitioning stockholder to accept the respondent corporation's tender of the undisputed portion of the value of the appraised stock.

NOTES

1 2013 WL 5878807 (Del. Ch. Nov. 1, 2013).

2 *Id.* at *13.

3 2014 WL 545958, at *3 (Del. Ch. Feb. 12, 2014).

4 8 Del. C. § 262; *see also Merion Capital LP v. 3M Cogent Inc.*, 2013 WL 3793896, at *3 (Del. Ch. July 8, 2013).

5 *Golden Telecom Inc. v. Global GT LP*, 11 A.3d 214, 217 (Del. 2010); *see also* 8 Del. C. § 262(h) (providing that, during an appraisal proceeding, the court "shall determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with interest, if any, to be paid upon the amount determined to be the fair value").

6 8 Del. C. § 262(h); *see also Highfields Capital Ltd. v. AXA Fin.*, 939 A.2d 34, 42 (Del. Ch. 2007) (determination of fair value requires examining "all factors and elements which reasonably might enter into the fixing of value," including market value, asset value, earning prospects, and the nature of the enterprise) (quoting *Weinberger v. UOP Inc.*, 457 A.2d 701, 713 (Del. 1983)).

7 *Weinberger*, 457 A.2d at 713; *see also Merion Capital*, 2013 WL 3793896, at *3.

8 *Golden Telecom*, 11 A.3d at 217-18.

9 *Cede & Co. v. Technicolor Inc.*, 684 A.2d 289, 299 (Del. 1996).

10 *Weinberger*, 457 A.2d at 713.

11 *Huff Fund*, 2014 WL 545958, at *2.

12 8 Del. C. § 262(h) (2001).

13 8 Del. C. § 262(h) (2013) (emphasis added).

14 *Huff Fund*, 2014 WL 545958, at *2.

15 *Highfields Capital*, 939 A.2d at 42 (quoting *M.P.M. Enters. v. Gilbert*, 731 A.2d 790, 795 (Del. 1999)).

[16] *Id.* (quoting *Van de Walle v. Unimation Inc.,* 1991 WL 29303, at *17 (Del. Ch. Mar. 7, 1991)).

[17] *Union Ill. 1995 Inv. LP v. Union Fin. Group,* 847 A.2d 340, 357 (Del. Ch. 2004); see also *M.P.M. Enters.*, 731 A.2d at 797 ("[Merger prices and prior offers] derived in the open market through arm's length negotiations offer better indicia of reliability than the interested party transactions that are often the subject of appraisals under Section 262."); *Highfields Capital*, 939 A.2d at 42 ("[If] the transaction giving rise to the appraisal resulted from an arm's-length process between two independent parties, and if no structural impediments existed that might materially distort the crucible of objective market reality, a reviewing court should give substantial evidentiary weight to the merger price as an indicator of fair value.") (internal quotation marks and citation omitted); *Dobler v. Montgomery Cellular Holding Co.,* 2004 WL 2271592, at *11 (Del. Ch. Sept. 30, 2004) ("[A] merger price resulting from arm's-length negotiations where there are no claims of collusion is a very strong indication of fair value.") (internal quotation marks and citation omitted), *aff'd in relevant part*, 880 A.2d 206 (Del. 2005); *Van de Walle*, 1991 WL 29303, at *17 ("The fact that a transaction price was forged in the crucible of objective market reality (as distinguished from the unavoidably subjective thought process of a valuation expert) is viewed as strong evidence that the price is fair.").

[18] It is well established that the fair price aspect of an entire fairness review in a breach-of0fiduciary0duty case and the fair value standard in a statutory appraisal "call for equivalent economic inquiries." *In re Orchard Enters,* 2014 WL 1007589, at *23 (Del. Ch. Feb. 28, 2014) (collecting authority). These standards differ "only in the appraisal statute's insistence on a point calculation when awarding fair value." *Id.* (citing 8 Del. C. § 262(h)).

[19] 11 A.3d 214 (Del. 2010).

[20] *Id.* at 216.

[21] *Id.* at 217-18.

[22] *See In re Orchard Enters.*, 2012 WL 2923305 (Del. Ch. July 18, 2012); *Merion Capital,* 2013 WL 3793896.

[23] *See Huff Fund*, 2013 WL 5878807, at *11 n. 119.

[24] 2012 WL 2923305 (Del. Ch. July 18, 2012).

[25] *Id.* at *5.

[26] 2013 WL 3793896 (Del. Ch. July 8, 2013).

[27] *Id.* at *5.

[28] 2013 WL 5878807 (Del. Ch. Nov. 1, 2013).

[29] *Id.* at *12 (emphasis in original).

[30] *Id.* (emphasis in original).

[31] *Id.* at *15 (emphasis in original)

[32] *Huff Fund*, 2014 WL 545958, at *1 (emphasis in original).

[33] 8 Del. C. § 262(h) (2013) (emphasis added).


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