Bloomberg Law

BNA's
Corporate Counsel Weekly™

Delaware Chancery Court Once Again Defers to Merger Price in Appraisal Proceeding (Part 1)

BY CHRISTOPHER N. KELLY AND MATHEW A. GOLDEN

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

Christopher N. Kelly is a partner and Mathew A. Golden is an associate in the Corporate Group of Potter Anderson & Corroon LLP. The views expressed by the authors are not necessarily the views of Potter Anderson & Corroon LLP or any of its clients.

 ISSN 0886-0475

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 presigning 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.

   ISSN 0886-0475