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

By 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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