Key 2016 Appraisal Decisions That Rejected Merger Price

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Law360, New York (December 6, 2016, 11:22 AM EST) -- There is a general perception that statutory appraisal challenges have been on the rise over the past several years. The Delaware Court of Chancery has issued a number of opinions during that time that use the merger price minus synergies as the best evidence of fair value. However, several notable opinions in 2016 have departed from this trend, relying instead on a discounted cash flow valuation derived from management projections and finding that the fair value for appraisal was significantly above the price paid by the acquirer in the transaction.

Background

Statutory appraisal under Section 262 of the Delaware General Corporation Law provides stockholders who dissent from a merger the ability to seek a judicial determination of the "fair value" of their shares on the "effective date," or the closing date of a merger.[1] In an appraisal action, fair value is determined "exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation," such as synergies, because the appraisal seeks to value the company on a "going concern" basis. In determining fair value, the Court of Chancery is required to take into account "all relevant factors."

Recent Trend Toward "Merger Price Minus Synergies" Valuations

In a string of recent appraisal cases, the Court of Chancery held that in certain circumstances, the fair value of the dissenting stockholders' shares was best determined by the per-share merger price less any merger-related synergies, rather than an analytical valuation method such as discounted cash flows. Last year, the Court of Chancery decided to defer to the merger price as the best indication of fair value in four separate appraisal cases. Merion Capital LP v. BMC Software Inc., C.A. No. 8900-VCG (Del. Ch. Oct. 21, 2015); LongPath Capital LLC v. Ramtron International Corp., C.A. No. 8094-VCP (Del. Ch. June 30, 2015); Merlin Partners LP v. AutoInfo Inc., C.A. No. 8509-VCN (Del. Ch. Apr. 30, 2015); In re Appraisal of Ancestry.com Inc., C.A. No. 8173-VCG (Del. Ch. Jan. 30, 2015). These holdings were not legally novel; merger-price-based appraisal valuation has been used since at least the 2004 Union Illinois 1195 Investment LP opinion. 847 A.2d 340 (Del. Ch. 2004). And in an important 2010 ruling, the Delaware Supreme Court clarified that the use of merger price as evidence of fair value was permissible but not required. Golden Telecom Inc. v. Global GT LP, 11 A.3d 214 (Del. 2010).

These cases suggest that the court is likely to apply a "merger price minus synergies" valuation if the sales process is thorough, effective and free from conflicts of interest. Additionally, the court has been more willing to defer to the merger price if the other evidence, such as the petitioners' expert valuation evidence, is seen as problematic. For example, the court has viewed discounted cash flow analyses as less persuasive than the merger price when the reliability of the projections, discount rates and other inputs to the financial analysis are effectively called into question.

Key 2016 Decisions That Rely on Discounted Cash Flow Valuations

While observers might have viewed recent decisions as ushering in a new deference to merger-price valuation in appraisal cases, three important cases in 2016 demonstrate that the court will utilize other financial analyses to determine fair value where it determines the merger price was not a reliable indicator.

In one recent decision, In re ISN Software Corp. Appraisal Litigation, C.A. No. 8388-VCG (Del. Ch. Aug. 11, 2016), the court determined the fair value of a closely held corporation whose controlling stockholder cashed out some, but not all, of the stock held by the minority stockholders. The court decided to rely exclusively on a discounted cash flow analysis because the method used by the controller to determine value was "unreliable," and neither historical sales of stock nor analyses of comparable companies and transactions provided reliable indicators of fair value. The parties' experts varied widely on the company's value, providing valuations ranging from $106 million to $820 million. The court chose one of the experts' discounted cash flow analysis as its starting point but adjusted several inputs and assumptions to conclude that ISN's fair value was $357 million — roughly 158 percent more per share than the merger consideration.

In another notable case, In re Appraisal of DFC Global Corp., C.A. No. 10107-CB (Del. Ch. July 8, 2016), stockholders sought appraisal when the company was sold to a private equity buyer, alleging that the $9.50 per-share merger price was a discount to the company's fair value. Because of the differing assumptions and weighting in their discounted cash flow and comparable company analyses, the experts for the petitioners and the company diverged widely on the fair value of the company, calculating per-share values of $17.90 and $7.94, respectively. The company urged the court to consider the $9.50 per-share merger price as the most reliable evidence of fair value. The court was not persuaded that any of the proposed metrics to value the company were reliable, primarily because the merger "was negotiated and consummated during a period of significant company turmoil and regulatory uncertainty, calling into question the reliability of the transaction price as well as management's financial projections." The court concluded that the most reliable determinant of fair value of the company's shares was a blend of three "imperfect" techniques: a discounted cash flow model, a comparable company analysis and the transaction price. Giving each equal weight and making adjustments to the various inputs and assumptions, the court held that the fair value of the company was $10.21 per share.

One of the most noteworthy decisions rejecting use of the merger price as evidence of fair value came in In re Appraisal of Dell Inc., C.A. No. 9322-VCL (Del. Ch. May 31, 2016). In the Dell case, Michael Dell, who founded and owned 15.7 percent of the company, teamed up in 2013 with private equity backer Silver Lake to take the company private. After an extensive sales process — which included competing bids from Carl Icahn and The Blackstone Group that ultimately pushed Silver Lake and Mr. Dell to enhance their offer — the company's public stock was acquired in a leveraged buyout (LBO) valued at $13.75 per share, or roughly $25 billion. In the post-trial ruling, the Court of Chancery determined that the fair value of the company was $17.62 per share, or roughly 28 percent above the merger price.

The court ultimately gave the merger price no weight in its fair-value determination, instead relying entirely on a discounted cash flow valuation. This is especially notable because the court's assessment of the sale process, led by the special committee of Dell's independent board of directors, was positive. The court found that the committee and its advisers "did many praiseworthy things" and that the process "easily would sail through" judicial review on a claim for breach of fiduciary duty.

Nevertheless, the court identified several factors that undermined the persuasiveness of using the merger price as evidence of fair value in the appraisal context. The court concluded that the original price generated by the presigning sales process — before the topping bids from Icahn and Blackstone — was less than fair value for several reasons:

- The use of an "LBO pricing model" meant that the price negotiations during the presigning phase were driven by the values financial sponsors were willing to pay, not the fair value of the company.

- Evidence suggested that there was a significant "valuation gap" driven by the market's short-term focus and the fact that the company's substantial long-term investments had yet to begin generating returns.

- There was no "meaningful pre-signing competition," which the court called "the most powerful tool that a seller can use to extract a portion of the bidder's anticipated surplus."

The court noted that post-signing topping bids are exceedingly rare in LBO transactions. But two such bids materialized for Dell, and though the original buyer eventually succeeded, the merger price was increased as a result of the bidding war. However, the court rejected the notion that the increase in consideration post-signing was proof that Dell stockholders received fair value for their shares. Rather, the price bump "demonstrated only that the stockholders received an amount closer to the highest price that a bidder whose valuation was derived from and dependent on an LBO model was willing to pay." The court identified several other reasons it was not comforted by the post-signing go-shop competition:

- The size and complexity of the company meant that a successful topping bid "would have been unprecedented."

- In management buyout (MBO) go-shops such as the Dell deal, "incumbent management has the best insight into the Company's value, or at least is perceived to have an informational advantage."

- Mr. Dell was himself an asset to the company, so a competing bidder who did not have him as part of the buyout group would be bidding for a less valuable company.

Ultimately, the court concluded that the "sale process functioned imperfectly as a price discovery tool, both during the pre-signing and post-signing phases." The court found that the merger process was "sufficiently credible to exclude an outlier valuation" such as the $28.61 per-share value advanced by the petitioners. But "sufficient pricing anomalies and disincentives to bid existed to create the possibility that the sale process permitted an undervaluation of several dollars per share.” Because the court found it “impossible to quantify the exact degree of the sale process mispricing,” it gave no weight to the merger price and instead relied exclusively on a discounted cash flow methodology to derive a fair value of the company.

Implications

Appraisal will remain one of the most closely watched areas of Delaware corporate law, as the number of appraisal cases continues to increase and courts further address the issue of merger price as evidence of a company’s fair value. For directors and officers of companies considering a sales process, there are a number of implications of the recent cases involving Delaware appraisal:

- Even a well-run sales process does not guarantee the use of the merger price as the basis for a determination of fair value.
    - Directors and officers who are well-motivated, independent, disinterested, informed and engaged during a sales process might not face serious allegations that they breached their fiduciary duties. Nevertheless, the merger still could be susceptible to an appraisal valuation higher than the merger price.
    - As best exemplified by the Dell case, depending on the circumstances of the transaction, the lack of a robust presigning market check can potentially diminish the company’s ability to persuade the court that the merger price (minus merger synergies) constitutes the fair value for purposes of an appraisal. The post-signing go-shop in Dell was at least somewhat effective, and the sales process as a whole appeared to demonstrate that the directors discharged their fiduciary duties. Yet, in the appraisal context, the court nevertheless relied on a discounted cash flow analysis for fair value rather than the merger price.
    - The process considerations that affect appraisal litigation are not just an issue for the target and its directors. Because the surviving corporation ultimately must pay any appraisal award, buyers may consider steps to minimize the risk of an appraisal case through the use of an appraisal-out condition or by structuring the transaction to avoid appraisal rights.
- Certain transaction dynamics and structures, including LBO/MBO transactions as in the Dell case, may involve particular risks in the appraisal context.
    - In certain contexts, the court may be less likely to adopt the merger price valuation framework in an appraisal action. If the court rejects the merger price in its determination of fair value, it likely will rely on a discounted cash flow and consider the projections and valuations used by the parties — including, for example, the internal rate of return calculations of an LBO sponsor or MBO group.

- In Dell, the court identified certain issues that led to its decision not to use the merger price as evidence of fair value. For example, in the context of that case, the court described the advantage to a private equity buyer of having management on its side as being "endemic to MBO go-shops" and creating "a powerful disincentive for any competing bidder." The court also stated that "the claim that 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."

- A discounted cash flow valuation based on management projections may result in fair-value determinations higher than the merger price.

  - As in the recent cases described herein, Delaware courts will at times give significant weight to management's projections of future revenues and cash flows. In fact, the Delaware Supreme Court has cautioned that while Delaware law does not require it, "[w]e expect many companies will advocate the same company specific data in appraisal proceedings that they have previously advocated in proxy materials." Golden Telecom Inc., 11 A.3d at 219. In an appraisal case where the respondent company urges the court to use lower projections than were used in connection with the sale process, the Court of Chancery "can — and generally should — consider and weigh inconsistencies in data advocated by a company." Id.

  - Where the court adopts the projections used by management, it may use different inputs and assumptions than those used by the company or its advisers in their financial analysis of the fairness of the transaction — potentially resulting in a higher valuation for the appraisal petitioners than calculated by the company's financial advisers in their fairness opinions.

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A version of this article appeared in Skadden's latest edition of Insights: The Delaware Edition.

[1] On June 16, 2016, DGCL Section 262 was amended in two significant ways. First, the new statutory amendments institute a "de minimis threshold" of $1 million or 1 percent of the outstanding stock. Second, the statute was amended to permit the respondent corporation to prepay, in its discretion, some amount of consideration to the appraisal

petitioners and thereby “cut off” the accrual of interest as to that amount. These amendments are further described in a March 16, 2016, client alert (available here).