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Delaware Appraisal Results Are More Predictable Than They Seem

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Right to appraisal in Delaware. A stockholder of a Delaware corporation who objects to the price to be paid in a proposed all-cash merger can petition the Court of Chancery to determine the "fair value" of his or her shares, so long as the stockholder has not voted for the merger or accepted the consideration paid in the merger and has complied with certain procedural requirements. The court will determine the value of all such "dissenting shares," based on the going concern value of the company immediately prior to the closing of the merger. The court can determine appraised fair value using any methodologies it chooses. The statutory proscriptions are only that the court (1) must consider "all relevant factors" and (2) cannot include any value that "arises from the merger" itself. The parties "share" the burden of proof, meaning that, as a practical matter, as the court has acknowledged, the burden is on the court to determine fair value.

Apparent uncertainty of the result in appraisal cases. Appraisal has been characterized by one Delaware law commentator as "a crapshoot." In our review of the appraisal decisions issued by the Court of Chancery from 2010 through September 2016, the appraisal award has varied from the merger price (not including statutory interest on the award) by amounts ranging from 14.5 percent below the merger price to 258 percent above the merger price (with an average premium above the merger price of 45 percent).

Factors that have led to uncertainty of the result in appraisal cases:

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• **Use of DCF methodology.** Historically, the court has most frequently utilized a discounted cash flow analysis to determine fair value, as this has been the methodology most widely accepted among financial analysts for determining a company's going concern value. A DCF analysis lends itself to unpredictable results, as there are myriad inputs to the analysis (including, most importantly, the management's projections, a discount rate, and a growth rate); many of the inputs involve highly subjective determinations; and even just a small change in just one input can have a very significant effect on the result. It has been routine for the petitioners' and the respondent's respective experts, even when they both have relied solely on a DCF analysis and have agreed on most of the inputs, to have widely divergent results. In one recent example (*ISN Software*, August 2016), where both parties based their valuation of the company on a DCF analysis, the petitioners' valuation ($820 million) was over eight times that of the respondent's ($106 million) (while the merger price implicitly valued the company at $137 million).

• **Judge's role as financial analyst.** The Court of Chancery's appraisal opinions are typically over 50 pages long, filled with detailed mathematical formulas and calculations, as the judges are required to select between the respective parties' experts' suggested inputs to the DCF analysis and/or to derive inputs from their own de novo financial analyses. The judges frequently note, as Vice Chancellor Glasscock characterized it (in the January 2015 *Ancestry* decision), the "difficulties, if not outright incongruities, of a law-trained judge determining fair value of a company … not simply because his training may not provide a background well-suited to the process, but also because of the absence of a burden of proof, which a judge relies on, like a shipwreck victim grasps a floating deck-chair or an ex-smoker hoards his last piece of nicotine gum."

The court will determine the value of all such "dissenting shares," based on the going concern value of the company immediately prior to the closing of the merger. The court can determine appraised fair value using any methodologies it chooses.

• **Apparently unpredictable use of the merger price.** In the past couple of years, the court has increasingly relied on the merger price as the sole or predominant indication of appraised fair value, leading many to believe that appraisal results would become more certain. The court has reasoned that, at least when (1) the sale process includes a meaningful market check, increasing the reliability of the merger price as an indicator of fair value, and (2) the available company financial projections (the primary input to a DCF analysis) are unreliable, decreasing the reliability of the DCF methodology in determining fair value, the merger price is the best indicator of fair value. Indeed, in 2015, in five out of the six appraisal decisions issued (*CKx*, *Ancestry*, *AutoInfo*, *Ramtron*, and *BMC Software*), the court relied solely on the merger price and determined fair value to be equal to (or, in *Ramtron*, after deducting merger-specific synergies, just below) the merger price. However, in 2016, in all three of the appraisal decisions issued to date (*Dell*, *DFC Global*, and *ISN Software*), the court did not rely solely or predominantly on the merger price (and the appraisal awards represented premiums above the merger price of 26 percent, 8.4 percent, and 250 percent, respectively). Particularly surprising to most observers was that the court chose not to rely solely on the merger price in *Dell* and in *DFC Global*, even though in both there had been a market check with seemingly competitive bidding. We note also that it remains an open issue how the court, when relying on the merger price, will (if at all) take into account, and thus deduct from the merger price, the merger-specific synergies expected and/or the control premium paid.

However, in our view, the uncertainty has been overstated.

• **First, appraisal is sought in only a small percentage of appraisal-eligible transactions.** Despite the significant increase in the filing of appraisal petitions over the past several years and the rise of so-called "appraisal arbitrage" (in which institutional stockholders or arbitrageurs buy shares after announcement of a merger for the sole purpose of seeking appraisal), it should be noted that appraisal petitions still are filed in a relatively small percentage of appraisal-eligible transactions (17 percent in 2013). We expect that, given the court's evolution toward greater reliance on the merger price in non-interested transactions, appraisal will become even more rarely sought in that context. Moreover, even appraisal petitions filed with respect to non-"interested transactions" typically represent a relatively small percentage of the shares.

• **Moreover, in our view, the results of the court's appraisal jurisprudence have been broadly consistent.** Our study of appraisal decisions issued since 2010 reflects that:

- In *"interested transactions"* (i.e., those involving a controlling stockholder, parent-subsidiary, management buy-out, or other element of self-interest on the part of the seller), the appraisal award frequently has been above (often, significantly above) the merger price. Further, in the case of interested transactions where there was essentially no market check as part of the sale process, the premium has averaged 138.4 percent (and in each case has been at or above 60 percent); while, in the interested transactions where there was some reasonable process that included a market check (even if it was viewed by the court as flawed or weak), the premium above the merger price has averaged 21.8 percent (and in each case has been at or below 26 percent).
- In *non-"interested transactions,"* the appraisal award has been equal or close to the merger price. In these cases, where the court deemed the sale process to have included a meaningful market check, there has been no premium; while, in the cases where the court did not view the process as having included a meaningful market check (or, as occurred in cases before 2014, did not address the strength of the sale process), the appraisal award was sometimes above the merger price, but by just 10-15 percent.

The three 2016 appraisal decisions have been viewed as creating uncertainty, but in our view have been consistent with the Court of Chancery's past jurisprudence.

• ***Dell*—interested transaction (with a market check).** *Dell* (May 2016) is notable for the fact that the court did not rely on the merger price, even though the sale process included competitive bidding. Importantly, however, *Dell* involved a going-private management-buyout in which the company's major stockholder (who was also the founder, CEO, and creator of the company's turnaround plan for the future) would be acquiring 75 percent of the resulting company shares. The involvement on the buy-side of a person who the court viewed as indispensable to Dell, together with his interests not being aligned with the other stockholders because he would be a substantial net buyer of shares rather than a net seller, compounded by a number of other factors, led the court to view the transaction, for appraisal purposes, as the equivalent of an "interested transaction." The court, utilizing a DCF analysis, determined fair value to be 26 percent above the merger price.

• ***ISN Software*—interested transaction (without a market check).** *ISN Software* (August 2016) was an "interested transaction" without any market check. The controlling stockholder, in a merger, cashed out some but not all of the two minority stockholders' shares. The controller determined the price; there was no financial advisor or fairness opinion. Based on a DCF analysis, the court determined fair value to be 258 percent above the merger price.

• ***DFC Global*—non-interested transaction (with a market check), but unusual business uncertainty.** *DFC Global* (September 2016) was a "non-interested transaction" and there was extensive post-signing shopping of the company, with competitive bidding. However, the court rejected sole reliance on the merger price to determine fair value, due to what it viewed as highly unusual circumstances (namely, the extreme regulatory uncertainty facing the company at the time of negotiation and consummation of the merger, as the payday loan industry was facing a complete regulatory overhaul that would potentially affect individual companies very differently). In the court's view, the unusual uncertainty, compounded by other factors, led to both the merger price *and* the company projections required for a DCF analysis to be unreliable. The court therefore utilized "a blend" of what it considered "three imperfect methodologies" (the merger price, a DCF analysis, and a comparables analysis), and determined fair value to be 8.4 percent above the merger price—which, given the small number of dissenting shares, represented an additional cost to the buyer of less than .03 percent of the transaction value.

Conclusion

• In our view, the result in an appraisal proceeding is, broadly speaking, predictable—notwithstanding a widespread perception that appraisal results are highly uncertain (as well as a number of important issues that remain open with respect to appraisal jurisprudence).

• Generally, for a "non-interested transaction" with meaningful competitive bidding, an appraisal award is not likely to significantly exceed the merger price. For an "interested transaction" without a market check, there will be a meaningful risk of an appraisal award above (potentially significantly above) the merger price.

• For transactions that fall between these two extremes, appraisal risk should approximate the extent to which the transaction is or is not "interested," and has or has not included a meaningful market check. (We note that the risk in a "non-interested transaction" may be mitigated when there has been a robust sale process with a meaningful market check and/or the controller's interests are aligned with those of the other stockholders.)

• In addition, special factors may undermine the reliability of the merger price as an indicator of fair value in the court's view—such as evidence that:

(1) the buyer viewed the timing of the purchase as particularly opportune to take advantage of temporary weakness in the company's valuation;
(2) the seller solicited only financial buyers and no strategic buyers;
(3) post-announcement, pre-closing developments significantly affected the value of the company (note that "fair value" is decided as of the date the merger closes, not as of the date it is announced); or,
(4) as a practical matter (although not legally relevant), post-closing developments suggest that the merger price severely undervalued the company.

• Or, special factors may undermine the reliability of a DCF analysis in the court's view—such as evidence that the management's financial projections are unreliable, including, for example, because:

(1) they were not prepared by management in the ordinary course of business;
(2) they were modeled to be aggressively optimistic or pessimistic, or otherwise may not reflect the management's best view of the company's future;
(3) there was unusual, extreme uncertainty regarding the company's future; or
(4) the company's record of projected versus actual results has not been reliable from an historical point of view.

Parties to transactions, when considering merger price and sale process issues, will want to factor into the calculus the risk associated with appraisal. Target company stockholders, when deciding whether to seek appraisal, will want to consider whether the transaction was "interested" or not, the nature and extent of the market check in the sale process, and the additional factors noted above that may influence appraisal decisions.